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TO AMEND THE BRETTON WOODS AGREEMENTS ACT TO AUTHORIZE CONSENT TO AN INCREASE IN THE UNITED STATES QUOTA IN THE INTERNATIONAL MONETARY FUND

96-2

HEARINGS

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL TRADE, INVESTMENT AND MONETARY POLICY

OF THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

HOUSE OF REPRESENTATIVES

NINETY-SIXTH CONGRESS

SECOND SESSION

ON

H.R. 5970

A BILL TO AMEND THE BRETTON WOODS AGREEMENTS ACT TO AUTHORIZE CONSENT TO AN INCREASE IN THE UNITED STATES QUOTA IN THE INTERNATIONAL MONETARY FUND

FEBRUARY 4, 6, 7; MARCH 20; APRIL 1, AND 21, 1980

Serial No. 96–57

Printed for the use of the
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TO AMEND THE BRETTON WOODS AGREEMENTS ACT TO AUTHORIZE CONSENT TO AN INCREASE IN THE U.S. QUOTA IN THE INTERNATIONAL MONETARY FUND

MONDAY, FEBRUARY 4, 1980

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON INTERNATIONAL TRADE,
INVESTMENT AND MONETARY POLICY,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, D.C.

The subcommittee met, pursuant to call, at 10:15 a.m. in room 2128, Rayburn House Office Building, Hon. Stephen L. Neal (chairman of the subcommittee) presiding.

Present: Representatives Neal, AuCoin, Cavanaugh, Blanchard, Evans, and Leach.

Chairman NEAL. The subcommittee will come to order.

This morning we begin hearings on H.R. 5970, a bill to authorize an increase in the quota of the United States in the International Monetary Fund. At present our quota is about $11 billion. This bill would increase it by about $5.5 billion, to a total of about $16.5 billion.

[The text of H.R. 5970 follows:]

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I

96TH CONGRESS
1ST SESSION

H. R. 5970

To amend the Bretton Woods Agreements Act to authorize consent to an increase in the United States quota in the International Monetary Fund.

IN THE HOUSE OF REPRESENTATIVES

NOVEMBER 27, 1979

Mr. NEAL (by request) (for himself and Mr. REUSS) introduced the following bill; which was referred to the Committee on Banking, Finance and Urban Affairs

---

A BILL

To amend the Bretton Woods Agreements Act to authorize consent to an increase in the United States quota in the International Monetary Fund.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That the Bretton Woods Agreements Act (22 U.S.C. 286–286k–2) is amended by adding at the end thereof the following new section:

"SEC. 32. The United States Governor of the Fund is authorized to consent to an increase in the quota of the United States in the Fund equivalent to 4,202.5 million Spe-

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cial Drawing Rights, to such extent or in such amounts as are provided in appropriation Acts.".

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Chairman NEAL. We have scheduled 3 days of hearings on this bill. Today we welcome the Honorable Anthony M. Solomon, the Under Secretary of the Treasury for Monetary Affairs. He is accompanied by Sam Cross, the U.S. Executive Director for the IMF.

On Wednesday and Thursday we will take testimony from private witnesses. The panel on Wednesday will address the question of IMF conditionality, particularly as it affects developing economies. IMF credit to a country in need of balance-of-payments assistance is conditioned upon agreement by the country to try to implement economic policies that in the judgment of the IMF are necessary to strengthen its balance of payments. These policies can be quite controversial, as they often require the debtor government to implement policies it would otherwise be unwilling to adopt.

The witnesses on Thursday have also been asked to present their views on IMF conditionality. In addition, they will address the question of the need for an increase in IMF quotas in the context of the problems confronting the international monetary system over the next few years.

Before we begin Mr. Solomon's testimony, I would like to ask unanimous consent that we include in the record the special report of the National Advisory Council on International Monetary and Financial Policies on the proposed quota increase. If there is no objection, it is so ordered.

[The special report referred to by Chairman Neal appears in the appendix to the hearings and may be found on p. 591.]

Chairman NEAL. I would just like to say a special word to Mr. Solomon. You have brought a level of understanding and good judgment to this job that I am sure will be sorely missed, and I just want to wish you every success in your new undertaking. You are a great asset to our country and I appreciate the work that you do.

I would like to yield to Mr. Leach at this time for any opening remarks.

Mr. LEACH. I don't have an opening statement, but I would like to concur in Chairman Neal's statement about your future, Mr. Solomon. Many of us look forward to the opportunity of your returning shortly after April 1 to give us the true scoop, when you can speak as a nongovernment witness. In any respect, I can't think of a more merited appointment, and we all wish you well.

Chairman NEAL. Mr. Solomon, please proceed as you will, and Mr. Cross, Executive Director, International Monetary Fund, welcome to you. Thank you for coming this morning.

STATEMENT OF HON. ANTHONY M. SOLOMON, UNDER SECRETARY OF THE TREASURY FOR MONETARY AFFAIRS, ACCOMPANIED BY SAM Y. CROSS, U.S. EXECUTIVE DIRECTOR, INTERNATIONAL MONETARY FUND; AND THOMAS B. C. LEDDY, DIRECTOR, OFFICE OF INTERNATIONAL MONETARY AFFAIRS, TREASURY DEPARTMENT

Mr. SOLOMON. Thank you, Mr. Chairman and Mr. Leach, for your kind words. I will miss working with this subcommittee. It has been very cooperative. I think we have worked well together, a good example of executive-congressional cooperation.

Before I read my short statement—I would like to submit a longer one for the record—I would like to introduce Thomas B. C.

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Leddy, Director of the Office of International Monetary Affairs of the Treasury Department.

Turning to the subject before the subcommittee, I appreciate your scheduling these hearings at an early date, and I am pleased to testify in support of the proposed increase in the U.S. quota in the International Monetary Fund. I have submitted a prepared statement for the record which goes into considerable detail about the role of quotas in IMF operations and the need for increasing quotas to equip the Fund to deal with the very difficult economic international situation we face today. I would like to stress the main points this morning.

First, Mr. Chairman, the purpose of the IMF is the maintenance of a strong and orderly international monetary system. It is not foreign aid. It is not commodity financing. It is not like any other institution that our country participates in.

The IMF has two basic functions, and they are closely related. The first is general guidance over the operation and evolution of the international monetary system. The second is provision of temporary financing in support of adjustment programs by IMF members facing balance of payments problems.

In its first function, the Fund has been given important new powers of surveillance over exchange rates and the balance of payments adjustment process, and the Fund membership has established the objective of making the special drawing right the principal reserve asset in the system.

The Fund's role and performance in these areas are of critical importance to the United States own interests. A strong IMF role in guiding the balance of payments adjustment process, encouraging appropriate adjustment by their countries, both surplus and deficit, can help ease pressures on the U.S. balance of payments and on the dollar. In parallel, a strong IMF role in the area of international reserves and liquidity can also help pave the way for an orderly evolution of the roles of the dollar, other currencies and the SDR in the reserve system.

The international monetary system is undergoing a period of major change and potential strain. The IMF is our central institution for monetary cooperation, and an important source of strength, stability, and broad direction as we try to contend with these changes. We need to recognize, of course, our own continuing large role in the world economy, and our responsibility for maintaining a strong U.S. economy and a sound dollar. But we need also to understand that a strong IMF role in guiding the system is of direct importance to our own efforts to strengthen the economy and maintain the integrity of the dollar.

The IMF's second main function, balance of payments financing for its members, is closely linked to its broader role in guiding the overall balance of payments adjustment process. The aim is to encourage timely adjustment by individual countries, through policies that are not destructive of national or international prosperity.

This objective is in the international interest, and every IMF member is obligated to support it in concrete, financial terms. This is a critically important point to bear in mind. The IMF is basically a revolving fund of currencies provided by every member. Every member must allow its currency subscription to be used by the

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IMF, and every member in turn has a right to draw on the IMF's currency pool when in balance of payments need. When a country's currency is used by the IMF, that country receives an automatically available claim on the IMF, which it can use to get needed foreign exchange when it runs into trouble.

So financing flows back and forth through the IMF depending on balance of payments developments. There is no set group of lenders or borrowers. Many IMF members, both developed and developing, have been on both sides of the ledger, providing their currency at times and drawing other currencies at other times.

In fact, while the U.S. quota subscription has been drawn upon many times over the years, our own drawings on the IMF are the second largest of the entire membership. As a net result of all IMF transactions in dollars over the years—dollar drawings and repayments by others, and the U.S. drawings—our quota subscription is basically intact.

IMF quotas are reviewed periodically, and have been increased four times in the IMF's history, in response to growth in the world economy and international trade and finance. These increase have been needed to keep the Fund's financing capability in some reasonable relation to demands that may arise.

Quotas are absolutely central in the IMF. They are the IMF's basic permanent resources. They determine the amounts countries can draw. They determine the distribution of SDR allocations. And, of key importance, they determine voting power. Because of these important advantages, the competition is always for increases in shares—not for reduction, as is the case in many other institutions.

The proposal for this quota increase resulted from a review that began in 1977.

Quotas had fallen to a very low level in terms of relevant world economic aggregates, and relative to the massive expansion of payments imbalances and international financing needs that took place during the 1970's. The desirability of an increase was generally accepted fairly early in the review—even though the amounts and shares had not been agreed. The IMF's temporary supplementary financing facility, approved by Congress in late 1978, was proposed as a bridging operation to this quota increase, since the negotiation and ratification of quotas is normally a very lengthy process.

The 50-percent increase ultimately agreed in December 1978—raising total quotas from about SDR $39 billion to SDR $58 billion—will barely halt the decline in the relative size of the IMF over the next 5 years. Many countries concerned about the outlook at that time pressed hard for a larger increase. The quota increase proposed for the United States is 50 percent, amounting to SDR $4,202.5 million, or about $5½ billion at current exchange rates.

This maintains the U.S. quota share intact. Given the continuing large role of the U.S. economy and the dollar in the international monetary system, maintenance of an appropriate U.S. share and influence over decisions on the system is particularly important. As I mentioned earlier, there is strong competition for increased quota shares and we successfully resisted pressures for a reduction in the U.S. share in this review.

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Developments since completion of the review and the IMF Governors resolution formally proposing the increase have only strengthened the need for a quota increase. The decade of the 1970s was an extremely difficult period—high inflation, low growth, emerging energy supply constraints, massive payments imbalances, and at times turbulence in the exchange markets.

The world economy came through these difficulties somewhat battered, but intact. The system functions. Trade and financing continue to flow internationally. Countries did not turn inward or go protectionist.

But all of these problems remain, and in the 1980's they may very well intensify. We are now faced with the consequences of another round of huge oil price increases, and with events in Iran and Afghanistan that greatly heighten the level of world concern and tension. These developments make it absolutely essential that we have in place the institutional framework for assuring monetary stability and for providing advice and support to countries as they contend with radically altered economic prospects.

Both financing and economic adjustment are going to be more difficult in this environment. The private financial markets will have to meet the bulk of expanded international financing needs—no other source is available—and development aid will continue to increase. But some countries will run into growing financing difficulties and pressures to bring their external balance into line with sustainable flows of financing.

Our own economic reliance on the world economy gives us a strong self-interest in assuring that those adjustments are made in a way consistent with our economic well-being—that they not lead to adoption of trade and capital restrictions, aggressive exchange behavior or unduly restrictive domestic measures. The IMF is the vehicle that exists to encourage such adjustment, and we must assure that it has the financial capability to be effective in that role.

We cannot predict the precise amount of IMF financing that will be needed. No one can. But we can foresee very tangible dangers to the system and to ourselves if the Fund's resources prove to be insufficient when they are called upon. If they ultimately are not fully called upon, the insurance will have cost us nothing.

I would like to mention a few other questions that I know are of concern to the subcommittee. From our experience with the supplementary financing facility, it is evident that there are two polar types of criticisms of the IMF. One is that the Fund is just another form of foreign aid, a giveaway. The other is that it is actually damaging and harmful to the interests of its members. Both of these criticisms reflect basic misconceptions about the IMF's purposes and functions.

The aid argument simply ignores the monetary character of the IMF and the fact that its sole purpose in providing financing is to encourge appropriate economic policies on the part of borrowers. This is not some altruistic gesture. It is fundamental to a smoothly functioning monetary system and, given the dollar's key role in the system, our interest is direct and unmistakable. The argument also ignores the fact that any IMF financing is temporary, short- to medium-term. And it ignores the fact that all members participate

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in financing IMF operations, and receive financing, depending on their balance-of-payments situation. Again, our own drawings from the IMF are the second largest throughout its entire history, and dwarf the drawings of nearly every other country.

The second view, that the Fund is harmful rather than helpful is also a serious misreading. In a sense, it also flows from a view that the IMF gives, or should give, development aid. The Fund is thus criticized for insisting on stabilization and adjustment, and for not permitting its financing to be used simply to sustain spending and consumption. The point is that when the IMF comes in, a country is in trouble.

The IMF's purpose—and our purpose in having an IMF—is to help the country get out of trouble and restore a position that it can sustain. If the Fund doesn't help, the country is going to have to adjust anyway, but in ways that may hurt itself more and may hurt us more.

The IMF's financing can ease the adjustment by providing breathing room. And if the IMF can encourage earlier adjustment, by offering significant financial support, then the ultimate pain may not be so great. But unless the United States and other countries are prepared to sustain a country's position on a more or less permanent basis with aid, adjustment is simply inescapable. It is not the purpose of the IMF to provide permanent support of this kind and I do not believe the Congress would want the IMF to become another aid vehicle.

On a related point, there seems to be a view that the Fund can go into a country and take over its basic social and political decisions. It is legitimate for the Fund to tell a country what it needs to do in terms of broad macro-economic policies—the budget deficit, monetary growth, the overall balance-of-payments deficit, and so forth—to correct its payments position and qualify for financing. But it is not correct for the Fund to tell a country that, within some overall budget total, it has to cut military expenditures and increase social welfare expenditures or vice versa. It cannot tell a country that it has to maintain employment in one area and cut it somewhere else. These are questions of basic national sovereignty. I know the United States would never accept such interference, and it is abundantly clear that other countries feel the same way.

In short, Mr. Chairman, the IMF has to encourage adjustment by its members. That is its purpose. We can, and do, encourage countries to select policies that respect and enhance basic human needs in their adjustment programs. But the IMF cannot take over its members' basic social and political decisions. It can recognize and adapt its policies to the changing needs and circumstances of members, and has in fact taken quite a few helpful steps in terms of expanding access to its resources and lengthening program periods.

It has also conducted a thorough review of its conditionality policies, and made a number of changes responsive to its membership's desires while maintaining the purposes for which it exists.

Before I conclude, Mr. Chairman, let me briefly mention the question of the budget and appropriations treatment of this quota increase. The President's budget proposes that a program ceiling on the increase be provided in an appropriations act. We have been consulting closely on this question with interested committees, and

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it appears that considerable interest is developing in an alternative approach which would involve full appropriations and budget authority for the increase, but which would not result in any increase in net budget outlays in connection with U.S. quota payments to the IMF. Under this approach, outlays in connection with transfers to the IMF would be offset simultaneously by budgetary receipts reflecting U.S. receipt of reserve tranche claims on the IMF.

Thus under either the program ceiling contained in the President's budget or this alternative approach, U.S. payments on its quota subscription would not affect net budget outlays or, therefore, the Federal deficit. We are continuing our consultations on this matter and will advise you of the results as soon as possible.

Mr. Chairman, the proposed quota increase is important for three reasons:

First, from the point of view of the international monetary system as a whole, it will help assure that the IMF can continue to meet its responsibilities for international monetary stability in a period of strain, danger, and financial uncertainty.

Second, from the point of view of individual countries, it will provide additional resources to encourage cooperative balance-of-payments adjustment policies—and I note that IMF resources have been of major direct benefit to the United States when we faced severe balance-of-payments pressures.

Third, from the point of view of the United States, it maintains our financial rights and our voting share in the institution, during a time when far-reaching changes in the monetary system—for example, a substitution account—may be under consideration.

The record of the IMF is a good one, in adapting to changing world circumstances and responding to the needs of its members. The proposed quota increase will provide the Fund with resources needed for its valuable work, and I urge the committee to approve this legislation.

Thank you.

[Mr. Solomon's prepared statement follows:]

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STATEMENT BY
THE HONORABLE ANTHONY M. SOLOMON
UNDER SECRETARY OF THE TREASURY FOR MONETARY AFFAIRS
BEFORE THE SUBCOMMITTEE ON INTERNATIONAL TRADE,
INVESTMENT AND MONETARY POLICY OF
THE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
HOUSE OF REPRESENTATIVES
FEBRUARY 4, 1980

Mr. Chairman:

I am pleased to appear before the Subcommittee in support of H.R. 5970, to provide for an increase of SDR 4,202.5 million in the United States quota in the International Monetary Fund.

The prospects for the world's economy as we enter a new decade are stark and sobering. Much of the seventies was characterized by high inflation, low real growth rates, soaring energy prices, severe payments imbalances and international monetary instability. Despite periods of marked strain, the international community weathered these difficulties reasonably well. But as we enter the 1980's, we must acknowledge that these problems not only remain but may well intensify, and that there is a danger of erosion in the patterns of cooperative behavior prevalent since the end of World War II.

The IMF is a cornerstone of U.S. international economic policy, providing the institutional framework for world monetary cooperation, finance and trade that is vital to our own economic health and prosperity. A strong and effective IMF is critical to our effort to assure world monetary and financial stability, and to provide the broad cooperative framework we will need to overcome fundamental economic difficulties. The proposed increase in IMF quotas is an integral part of that effort.

The IMF serves two related functions -- general guidance of the monetary system, and provision of temporary balance of payments financing.

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First, its Articles of Agreement constitute the operating rules of the international monetary system and establish member countries' obligations to promote a cooperative and stable world monetary order. The decade of the seventies brought major changes in the international monetary system and in the IMF's role in guiding the system's operations.

In the area of balance of payments adjustment, the Bretton Woods par value exchange rate obligations have been replaced by obligations on members to pursue policies to achieve the underlying economic stability that is needed for genuine and sustained exchange rate stability The IMF has been given the task of surveillance over members' compliance with those obligations, and over the operations of the balance of payments adjustment process more generally.

In the area of international liquidity the IMF membership has established the objective of making the Special Drawing Right (SDR) the principal reserve asset in the international monetary system.

These changes are not abstractions. They have paralleled and to a large extent reflected changes in the position and role of the dollar in the system. The original Bretton Woods arrangements assumed a fixed and central role for the dollar, with the U.S. position essentially passive and the product of other countries' actions in pursuing their own balance of payments policies and objectives That arrangement ultimately became both unsustainable and intolerable in terms of U S. economic interests. The new arrangements have provided much more scope for balance of payments adjustment by the United States and recognize the need for greater symmetry in encouraging adjustment by all nations -- those in surplus as well as those in deficit

At the same time the world's reserve system has been undergoing significant change Increases in the relative economic size and financial capacity of other major countries have tended to bring some growing use of their currencies in international transactions and reserves On the one hand, such a development could help to mitigate some of the burdens on the dollar and U.S finan cial markets that arose from its extremely large international role. On the other hand, the process of change can itself be unsettling and disruptive, and there is a widespread view that increasing reliance on the SDR -- an internationally created and managed reserve instrument would be preferable to development of a full-scale multiple currency reserve system. The IMF over the past few years has taken a number of important steps to promote the role of the

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SDR, and is presently considering a potentially significant further step in its examination of the substitution account.

The dollar, of course, remains critically important to the operation of the international monetary system, and the U S. economy remains a powerful element of that system. This will continue to be the case, and we recognize and accept the responsibilities incumbent on the United States to maintain a sound economic position and a stable dollar. At the same time a strong IMF -- able to encourage effective economic and balance of payments adjustment by all countries, and able to guide the orderly evolution of the reserve system -- is of direct and immediate importance to our economy and to our efforts to maintain the integrity and strength of the dollar.

The second basic function of the IMF, closely tied to its role in guiding the overall operation of the system, is the provision of temporary financing in support of members' efforts to deal with their balance of payments difficulties. Its aim is to encourage timely correction of balance of payments problems in a manner that is not distructive of national or international prosperity -- and thus to promote a smoothly-functioning world payments system in the context of a strong and stable international economy. This is a central objective of the IMF, and one in which all must participate as an obligation of IMF membership.

It is important to understand the nature of IMF financing. The IMF is essentially a evolv ng fund of currencies, provided by every member and available to every member for temporary balance of payments financing under prescribed c teria. Each country is obligated to provide its currency to the IMF to finance drawings by other countries facing balance of payments needs; and each country in turn has a right to draw upon the IMF in case of balance of payments need. When a country provides financing to the IMF that is, when its currency is drawn from the Fund -- it receives an automatic and unchallengeable right to draw that amount from the IMF in usable foreign exchange. This is the so-called "reserve position" in the IMF an automatically available reserve claim on the IMF which is normally carried in countries' international monetary reserves.

Financing thus flows back and forth through the IMF depending on balance of payments patterns and financing requirements at any g ven time There is no set class or group of lenders or borrowers no concept of "donor" or "recipient. All major industrial countries have drawn upon the IMF at times and many members developed and developing alike, have been on both sides of the financing and drawing ledger during the history of their participation in the IMF.

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The current situation is a case in point. On a cumulative basis over the past 33 years, the U.S. quota subscription has been drawn upon many times, in amounts totaling many billions of dollars. But there have also been repayments of these drawings, and drawings on the IMF by the U.S. itself have been ve y large over the years the equivalent of about $7 5 b llion second only to cumulative drawings by the United Kingdom. As a result, the net U.S. position v s-a-vis the IMF is very nearly ba anced today. That is, on a net basis, the U.S currency subscription to its quota is intact -- there has been no net cash drain to the Treasury -- and the U.S. has actually made small net use of its basic reserve tranche position in the IMF established through earlier subscription payments in reserve assets.

These changes in the U.S. position vis-a-vis the Fund over the years reflect the ups and downs in the U.S. balance of payments. At times we have provided financing to the IMF, at times we have drawn upon it. At present the IMF is not drawing on the U.S. quota subscription to finance drawings by other nations, though it presumably will in the future in light of developments in our balance of payments.

Role of Quotas

Throughout its history, the IMF has needed periodic increases in its quotas in response to the rapid growth of world economic activity and international trade and financial transactions. To maintain a strong IMF, capable of encouraging needed adjustment while providing the temporary financing required to maintain monetary stability, we must assure that its resources are adequate to meet potential demands. The proposed 50 percent general increase in IMF quotas is a key element in assuring that strength.

Quotas play a central role in the IMF. Members' quota subscriptions constitute the IMF's permanent financial resources. Quotas determine both the amount of IMF resou ces a member can draw when in balance of payments need, and its obligation to provide resources when its balance of payments is st ong Quotas determine the distribution of SDR allocations. And,of key importance in all IMF operations, quotas also determine voting power. Unlike the case in many institutions, where member countries try to hold down their shares of participation in the IMF countries compete to gain the largest possible share of the total because of the votes and financing that a larger quota share provides The Un ted States has by far the largest IMF quota, and thus the largest share of votes and potential access to IMF resources As I noted earlier, over the years the United States has made larger total drawings on the IMF than any other member except the United Kingdom. The most recent U.S. drawing was in November 1978, when we

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drew $3 billion in Deutsche marks and Japanese yen from the IMF as part of the major program of dollar support operations we initiated at that time.

The IMF's basic financing operations are conducted under its "tranche" policies. First is the "reserve tranche." The member can draw its reserve tranche automatically and there are no charges, policy conditions, or repu chase obligations. Beyond that are "credit tranches," each amounting to 25 percent of the member's quota, where drawings are subject to appropriate charges, policy conditions, and "performance criteria." The IMF also has a number of special facilities geared to particula balance of payments difficulties which members may draw upon on the basis of specified criteria Access to these facilities is also based on quotas. The conditionality requ ement ties in to the need for a quota increase If the IMF is to play an influential role in encouraging countries to undertake the difficult policy ad ustments which are needed and appropriate to the common interest, the IMF must be able to ease the costs of adjustment by providing members with adequate financial resources.

Proposed Increase in Quotas

To ensure that IMF quotas remain realistic and adequate, they are reviewed periodically in relation to the growth of international transactions the size of payments imbalances and financing needs, and world economic prospects. Such a review was initiated in 1977, and led to a resolution adopted by the IMF Board of Governors on December 11, 1978, with the U.S. Governor concurring, calling for an increase in overall IMF quotas by 50 percent, raising total quotas from about SDR 39 billion to roughly SDR 58 billion. The increase proposed for the U.S. quota amounts to SDR 4,202.5 million, equivalent to about $5-1/2 billion at current exchange rates. This increase would raise the U.S. quota by 50 percent, from SDR 8,405 million (or about $11 billion) to SDR 12,607.5 million (or about $16-1/2 billion).

The negotiation of quota shares is always difficult, with pressures on the U.S. to accept a smaller quota share. Given the key roles of the dollar and the U S. economy in the international monetary system, and the IMF's central ole in guiding the operations and evolution of the system, t is essent al that the U.S. maintain an appropriate share of quotas and votes, and thus its influence over basic decisions about the system. In the end, the pressures for a reduced U.S. share were successfully resisted during the most recent review, and only a very few selective changes in quota shares, all within the LDC group, were agreed.

The decision to propose a 50 percent overall increase in quotas reflected a widely felt view that quotas had, by any

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measure, failed to keep pace with potential balance of payments financing needs. Despite quota increases on four occasions during the IMF's history, aggregate quotas had fallen to about four percent of annual world imports, in comparison with 8 to 12 percent during the 1960s and 10 to 14 percent during the 1950s. The adequacy of quotas had eroded particularly during the seventies, as the ratio of quotas to members aggregate deficits fell by two-thirds between 1971-73 and 1978. In mid-1978 the Fund s usable quota resources -- that is, its holdings of the currencies of members then in strong payments positions -- totaled only about SDR 16 billion, or just over one percent of world imports. In November 1978 before the Supplementary Financing Facility was put in place the amount of usable quota resources was effectively halved to around SDR 8 billion, when the U.S. drew the equivalent of $3 billion and the dollar was taken off the IMF's "budget" of currencies used in financing current drawings.

These shifts in the IMF's "liquidity" illustrate the difficulties of projecting either the level of usable IMF resources or the level of future drawings on the Fund In its 1977 quota review, the IMF estimated that the level of international transactions between 1978 and 1983 would ncrease by 60 percent in SDR terms. In fact, that 60 percent figure is now much too low as inflation, oil price increases, and other factors have caused a much more rapid expansion in the value of world trade and financial transactions. And even if we could accu ately predict future levels of world trade we would not know the pattern of trade, the size and distribution of payments imbalances, or the availability of financing from banks and other sources.

In determining how large a quota increase would be needed, it was recognized that the IMF's Supplementary Financing Facility, introduced last year to provide badly needed resources to the IMF on a temporary basis, would be phased out after a 2-3 year period. That Facility was proposed and is regarded as a bridging operation, to be followed by an increase in the IMF's permanent resources.

It was in the light of these considerations that the IMF membership concluded that a 50 percent increase in total quotas would be the min mum required to assure that the IMF remained in a strong position to meet prospective needs. Even a 50 percent increase will do little more than halt the decline in the relative size of IMF resources into the mid-1980's. In fact most developing countries and some OECD members, fearing growing world economic uncertainties pressed hard for a much larger increase.

Events since completion of the quota review have strengthened the justification for the quota increase. Oil market developments have again radically altered economic prospects and drawn the world into a pattern of payments imbalances reminiscent of that following the 1973-74 oil price increase. Countries must, and will,

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begin adjusting to these developments, and that will cause further changes in world balance of payments patterns and financing needs that cannot be foreseen. Mo eover, events in Iran and Afghanistan have created a climate of concern and uncertainty that makes it all the more important to have in place the institutional means for assuring monetary stability and providing advice and financial support to countries facing the growing economic and financial problems of the 1980s.

At present the IMF has usable quota resources estimated at about SDR 10 billion, plus SDRs held by the IMF totaling approximately SDR 900 million These resources are supplemented by amounts remaining under the General Arrangements to Borrow equal to SDR 5.7 billion, and SDR 7.4 b llion under the Supplementary Financing Facility, which is scheduled to end in early 1981 or 1982.

Severe payments imbalances and consequent financing needs will very likely intensify during the next several years. At present, in broad terms, we anticipate an OPEC cur ent account surplus of about $110 billion in 1980, and current account deficits, after official transfers, of about $60 and $50 billion for the OECD and LDC group respectively. A world env ronment of slower growth, high inflation, heightened caution in the private financial sector, and the continuing threat of energy supply disruptions will simultaneously make the financing of external deficits and the adjustment of national economies to reduce those deficits more difficult The private financial sector will again meet the bulk of expanding international financing needs -- there is no other source for the magnitudes that will be required -- and flows of official development assistance will continue to rise. But we have to anticipate that a number of countries, developed and developing, will encounter growing financial difficulties and pressures to adjust and bring their external positions closer into line with sustainable flows of financing. Early in 1980, the IMF is already processing requests for balance of payments financing that far exceed the total drawn in 1979 as a whole.

The IMF must have adequate resources and this means adequate quotas to encourage countries to adjust in an appropriate way, rather than adopt trade and capital restrictions agg essive exchange rate policies, or unduly restrictive domestic measures in order to reduce their financing needs Such restrictive measures could have serious implications for the ent re world economy and the prosperity of all nations, as well as for the economy of the country introducing them. We must not forget the lessons of the 1930's, when serious economic troubles were worsened by ultimately self-defeating actions of nations trying individually to preserve employment and prosperity during times of economic distress and international tension The impact on the United States today could be especially harmful. Our economy has grown heavily reliant on world trade and financial flows. An interdependent world brings real economic benefits, but also greater vulnerability to outside developments. Imported goods, from raw

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materials to high technology products, are integrated into all phases of U.S. economic activity. Export ma kets constitute a major source of demand for U.S. goods and services One out of every 7 U.S. manufacturing jobs and one out of every 3 acres of U.S. agricultural land produce for export. For the U.S economy specifically and the world economy generally, prosperity is dependent on a well-functioning international financial system.

Uncertainties about the magnitude, distribution and financing of payments imbalances over the next few years make it impossible to project the precise level of IMF resources that will be used during the next five years. But we must assure ourselves that the IMF's resources are sufficient to enable it to meet its important responsibilities -- sufficient as measured against historic standards and current trends, and sufficient against a realistic appreciation of the dangers we face as we enter a new decade.

Specific Concerns

I would now like to turn to some specific questions of possible concern to the Comm ttee. I am well aware that there are two widely different views of the nature and role of the IMF in dealing with ts member countries One is that the IMF is just another form of foreign aid The other is not only that the IMF does not aid its members but that its operations are actually inimical to their interests -- put baldly, that the IMF, as a condition for borrowing, requires austerity measures that bear most heavily on the poorest segments of the population, depriving them of basic human needs and leading to repressionist regimes that deny human rights and political freedom.

Neither characterization fits the IMF. It is a unique institution, unique in purpose, structure and operations. The view that it is development aid ignores its basic purpose of providing the institutional framework for international monetary cooperation and stability It ignores the fact that IMF financing is provided on a temporary basis in support of members' programs -- often involving extremely difficult policy choices to overcome their balance of payments problems in ways that are consistent with the interest of the international community in general And t ignores the fact that all countries provide financing to the IMF and receive financng from the IMF depending on their balance of payments circumstances at any given time. Again, all industrial countries have drawn on the IMF, and drawings by the U.S. and U.K. have been the largest of all.

The contrary view also reflects a serious misunderstanding of the IMF and its operations. The IMF is in business to help its members and improve conditions for their populations --

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though this may well require difficult policy choices -- not the reverse. And the IMF is making a continuing effort to adapt itself to the changing circumstances and needs of its members.

The Fund has in recent years taken a number of steps to improve its effectiveness and ability to meet membe s changing needs. First, reflecting the generally increased scale and persistence of balance of payments problems the IMF now provides more financing for longer periods for nations with adjustment problems Quota limits on drawings have been expanded; and for drawings with higher conditionality, in the upper credit tranches, two and three year programs have become much more the accepted rule, in contrast to the one-year program that was traditional in earlier days.

Second, the IMF has undertaken a major review of conditionality in the upper credit tranches, and has established a new set of guidelines for its application. To an extent the new guidelines formal ze certain protections for borrowing countries that had already existed in practice, but they also added important new features. For example, they now emphasize the desirablity of encouraging countries to adopt corrective measures at an early stage -- before very severe adjustment problems arise -- and recognize the need for more gradual and more flexible adjustment over longe periods. They also recogn ze that adjustment measu es frequently encompass sensitive areas of policy, and provide that in helping to devise adjustment prog ams the Fund will pay due egard to the concerns of governments about the compatibility of such programs with their domestic social and political objectives and economic priorities They provide that "performance criteria will normally be confined to macro-economic variables other than those pe formance criteria needed to implement specific provisions of the Articles, such as the avoidance of exchange restrictions). The new guidelines should help dispel the idea that cond tional ty is a weapon for imposing unnecessary hardship and make clear that for countries with severe imbalances, the adequate and timely adjustment which is the objective of IMF conditionality is in the best interests of both the individual country involved and the world community.

The third change in the IMF's approach to adjustment, and a particularly important one, is one that I stressed earlier -- its new role in surveillance. Surveillance over every IMF member's efforts to foster orderly underlying economic and financial conditions provides valuable IMF leverage for promoting sound adjustment policies by all countries surplus or deficit, whether or not they draw on the IMF s resources It is designed to introduce a badly needed symmetry in the international monetary system more effectively encouraging adjustment efforts by surplus countries, and not leaving the entire burden of adjustment on deficit countries Development of IMF surveillance can be helpful in various ways. To the extent it encourages earlier adjustment action,

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it helps to avoid the more severe corrective measures which become necessary as a country's situation worsens; and to the extent it encourages adjustment action by all countries with large imbalances, it reduces the relative emphasis on those deficit countries drawing upon the IMF.

It is generally agreed that the conditionality attached to IMF lending in the upper credit tranches is essential to achievement of the IMF's purposes. Whatever the cause of a country's balance of payments problem, unless it is temporary and self-reversing, the country will ultimately have to adjust -- it cannot indefinitely spend reserves and borrow abroad. Restrictions on trade and on exchange transactions may provide temporary relief, but can lead to pervasive distortions in the economy and retaliation from abroad. If policy adjustments are delayed too long, the country's creditworthiness and ability to borrow abroad will inevitably decline, trade credit will evaporate, investment will generally fall, and growth will decline or become negative. This in itself is one form of adjustment, but it is a harsh and inefficient adjustment. What may look like the easy way out is in fact very costly.

Most governments will make policy adjustments before the situation deteriorates to that extreme, but sometimes a country will not approach the Fund until the situation is desperate. This is a key point to remember. The Fund does not cause the lack of foreign exchange that interrupts vitally needed imports -- blaming the IMF for a nation's economic problems is somewhat like blaming the doctor for one's sickness. Indeed the IMF, oftentimes alone, tries to help by providing resources to maintain the economy and balance of payments temporarily, and by providing policy advice to restore sustained economic stability and growth. In return for this financing, the world community expects the government to foreswear measures disruptive to the world economy. To assure repayment, and the most beneficial results for the country, the Fund requires that the member undertake appropriate measures to solve its balance of payments problem. But the point to emphasize is that barring a major change in the country's economy -- such as discovery of oil, or a political decision by other nations to finance the deficits of the country, on a more or less permanent basis -- every nation will have to adjust, and in most cases the sooner the better, for the longer adjustment is delayed, the more difficult it will be.

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With respect to the contention that IMF adjustment programs bear largely or wholly on the poorest classes, the Fund's Managing Director has commented as follows:

> "The Fund avoids taking a view on the appropriate distribution of the burden of adjustment as between various sections of society Thus, for example, if an improvement n the government budgetary position is an ingredient of the program as is very frequently the case, the performance criterion usually applied relates to the extension of bank credit to the government rather than to spec fic measures to increase revenues or cut expenditures. Similarly, performance criteria do not relate to specific prices for ind vidual commod ties but when needed, apply to prices fundamentally influencing the structure of production like exchange rates and interest rates."

The reasons why the Fund takes this approach are practical and philosophical. It is appropriate for the IMF to say how much adjustment a country should undertake as a condition for obtaining financing. But the IMF should not tell a country whether it must cut military expenditures or social programs or that it must increase one tax rather than another, or which social group should bear wh ch burden These detailed implementing decisions must be made by the government concerned. I am sure the United States Congress would never accept such interference with U.S. sovereignty. Neither will other countries

There are various policy combinations which would permit a country to meet the targets negotiated with the IMF, so the member presumably chooses one that most conforms to its particular circumstances and objectives. Of course the IMF may well have views of what are efficient and equitable policy mixes and can discuss these with a prospective borrower if appropriate. There are cases where the Fund staff has advised against certain actions because of the r likely social costs. The U.S. has, on a number of occasions urged the Fund to suggest programs to governments that are conducive to development and social goals, while meeting overall economic requirements. But in the end the individual government is responsible for its own stabilization program -- both in design and implementation even though domestic pol tical purposes may be served by making the IMF the scapegoat for unpopular policies.

Mr. Chairman, the IMF must encourage meaningful balance of payments adjustment by its members, in the interests of maintaining a stable world monetary order. That, not aid, is its purpose. But it must also exe t its influence in areas of economic policy that are appropriate to its purposes and nature -- it cannot arrogate powers that no soverign state will yield. At the same time, the IMF can be -- and is -- alert to the needs and circumstances of its members, adapting as appropriate to meet the changing requirements of an evolving world economy.

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Budgetary Treatment of IMF Quota Increase

Before I conclude, Mr. Chairman, let me briefly mention the question of the budget and appropriations treatment of this quota increase. The President's budget proposes that a program ceiling on the increase be provided in an appropriations act. We have been consulting closely on this question with interested committees, and it appears that considerab e interest is developing in an alternative approach which would involve the following:

-- Appropriations would be required in the full amount of the increase, and that sum would be included in budget authority totals for fiscal year 1981.

-- Payment of the quota increase by the United States would result in budgetary outlays only as cash transfers are actually made to the IMF on the U S quota obligation 25 percent of our quota inc ease will be transferred immediately in the form of SDR; subsequent transfers can occur when dollars are needed by the IMF in its operations).

-- Simultaneously with any cash transfer under the quota subscription an offsetting budgetary receipt, representing an increase in the U.S. reserve position in the IMF, would be recorded.

-- As a consequence of these offsetting transactions, transfers to and from the IMF under the quota obligations therefore would not result in net outlays or receipts.

-- Net outlays or receipts resulting from exchange rate fluctuations in the dollar value of the SDR-denominated U.S. reserve position in the Fund would be reflected n the Federal budget. These net changes cannot be projected and thus would be recorded only in actual budget results for the prior year.

Thus under either the program ceiling contained in the President's budget or this alternative approach, U.S. payments on its quota subscription would not affect net budget outlays or, therefore, the Federal deficit. We are continuing our consultations on this matter and will advise you of the results as soon as possible.

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Conclusion

Mr. Chairman, the proposed quota increase is important for three reasons.

First, from the point of view of the international monetary system as a whole, it will help assure that the IMF can continue to meet its responsibilities for international monetary stability in a period of strain, danger and financial uncertainty.

Second, from the point of view of individual countries, it will provide additional resources to encourage cooperative balance of payments adjustment policies -- and I note that IMF resources have been of major direct benefit to the United States when we faced severe balance of payments pressures.

Third, from the point of view of the United States, it maintains our financial rights and our voting share in the institution, during a time when far-reaching changes in the monetary system -- for example, a substitution account -- may be under consideration.

The record of the IMF is a good one, in adapting to changing world circumstances and responding to the needs of its members. The proposed quota increase will provide the Fund with resources needed for its valuable work, and I urge the Committee to approve this legislation.

Chairman NEAL. Thank you, Mr. Solomon. It is my understanding that other countries of the world that participate in the IMF look to the United States for leadership in increasing the quota, at the very least. What would happen if we were not to participate this year?

Mr. SOLOMON. I think it would be a disastrous setback for our leadership generally in the world. I think it would have very far-reaching implications. I don't think the importance of the Fund is fully understood by public opinion, because it is a fairly technical and unique institution, but governments all around the world think of it as the central institution for trying to promote world economic growth and monetary stability.

For the United States to fail, when we have been the leaders in founding the Fund and in maintaining the Fund strength and given the role of the dollar in the monetary system, for us to fail to approve the full increase that we ourselves are instrumental in negotiating would have very far-reaching consequences, extending way beyond the monetary area.

In fact, the thought staggers my mind. We have never in these 30 to 35 years since we created the Fund failed to implement fully the quota increases, and I would have to think through the consequences of that in specific terms. The OPEC surplus countries are probably going to run a surplus of about $110 billion this year. There is a general concern about recycling through the private markets, and therefore a potentially larger recourse to official financing, particularly the Fund. I think that one of the results of the failure to enact the full amount would probably be considerable reaction in international borrowing and lending markets, and I don't know what the other ramifications would be, but they would be very serious, Mr. Chairman.

Chairman NEAL. You would also predict that there would be, probably out of perceived necessity, a return to much more restrictive trade policies?

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Mr. SOLOMON. Without any question. The IMF plays an absolutely critical role, as I explained in my testimony, in promoting the kind of adjustment which does not lead to the kinds of restrictive measures which not only damage the long-term future of the particular country involved, but damage all the rest of us as well, and constructive type of adjustment is the thing that we need, and we need even more of it.

The IMF is doing a good job, but I hope over the years it will expand considerably its influence, and do an even better job with more clout in regard to promoting the right kind of adjustment, and that is true for the large countries as well as for the small countries.

Chairman NEAL. I personally think that the IMF provides the framework, the basis for some kind of reasonable world trade which benefits us all. I would just hope that as we proceed with this legislation, that those in the American public who follow trade questions and who recognize the negative impact of our trade deficit on our economy would support this kind of legislation. I just send that message out to whoever might want to hear it.

Often I have found that we get very excellent support for measures that directly benefit trade, such as Export-Import Bank legislation, but when it comes to these broader issues, often those who could be of some help are silent, and I would just hope that they would take a more active role in this IMF legislation.

What would happen if the Congress were to add political considerations to the IMF, in your opinion?

Mr. SOLOMON. The charter, as you know, says that only economic considerations can be taken into consideration. The United States played a major role in insisting on that, at the time that the Fund was created. The political scene just changes constantly in many countries. One day the country is on the bad list. The next day the government changes and it is on the good list, or vice versa. You have an absolute shambles, Mr. Chairman. There is no way of having an orderly economic system if the IMF—the institutional expression of that system is politicized.

In fact, it is important to realize that when an IMF member draws on the IMF, it is the country that is responsible for repayment. The IMF is not influenced by any change in government. We had the controversial case of Nicaragua last year. Well, the Somoza government made a drawing from the IMF because it met technical economic criteria, and then later on the new government in Nicaragua has also made a drawing, and this constantly happens. If we were to introduce political criteria, first of all, I think they would be ineffective. The overwhelming majority of the Fund membership would not permit us to do that. I just think the institution would grind to a halt.

Chairman NEAL. Are you familiar with a letter our colleague Tom Harkin sent to members of the subcommittee?

Mr. SOLOMON. Yes, I have seen a draft of the proposed letter. I don't think I have seen the letter.

Chairman NEAL. I will give you a copy of the letter. It describes some of the intent of the amendments and includes several amendments. Have you had a chance to look those amendments over yet?

Mr. SOLOMON. Yes.

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Chairman NEAL. What would be your general comment on those amendments?

Mr. SOLOMON. There are various sections to that. Let me say in general terms, first of all, that we sympathize with Tom Harkin's overall concerns. Governments sometimes do ignore basic human needs, and they spend excessively on defense. Sometimes they have social and economic priorities that are out of kilter with what we think are appropriate, by any standard of human decency. But the amendment basically is at odds with the more limited function of the IMF, which is also important to us.

We are interested in a sound international monetary system, and we cannot solve social and economic priorities in different countries and different cultures by loading it onto the monetary system. It is not going to help us to have a scrambled and screwed up monetary system by trying to use this particular vehicle for solving these very deep seated and frequently shifting problems as governments—and their social and economic priorities—change in particular countries.

Having said that in general terms, some of the provisions are probably workable, and we would be happy to sit down and consider detailed drafting problems. I mean, for example, section A, in which we encourage countries to adopt programs that foster achievement of basic humans needs and objectives, is one that we would be prepared to support.

During the last year, Mr. Cross in the Fund, has been working with other Directors, and with the Managing Director in regard to amendment that was passed in regard to the supplementary financing facility, which is similar to this in some ways. Section E may provide the basis for a workable provision, though I think it is very important to understand that adjustment may inescapably require short-term retrenchment by all sectors of the population and thus we should focus the provision on the longer-term effects of the program.

Look, there is no escaping the fact that if a country has waited too long, and placed itself into terrible trouble, that a retrenchment program is going to bear on all segments of the population, and when 80 percent of an LDC, for example, is what we would consider poor, by any decent criteria, there is no escape from the fact that all segments of the population will, to some degree, be affected in the short term, but over a longer term period, the 2- to 3-year period let's say in which adjustment is required, you will be providing a basis for resuming sound economic growth which will be of major benefit to that 80 percent.

I could go through the various technical sections if you wish, Mr. Chairman. I could mention that there are some sections we believe are not workable. Sections B, C, and D. Apparently mean that decisions on IMF financing would be based not on whether the program would help stabilize the economy, and lead to future growth by correcting the balance of payments problem and the inflationary problem, but on whether the program would meet specified social objectives and criteria, and there we get back to the basic point.

To the degree that the IMF is still pursuing its stabilization and monetary function, there may be flexibility for consideration of

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basic human needs, but any criterion which diverts the IMF from considering the economic criteria to meeting purely social criteria would basically be a distortion of the IMFs function and would make it ineffective.

Chairman NEAL. From an IMF function to an aid function essentially?

Mr. SOLOMON. Right, or to a humanitarian function.

Chairman NEAL. Or a humanitarian function?

Mr. SOLOMON. Right.

Chairman NEAL. I wonder if you would all please go through these amendments, look at them carefully, and let us know what you think makes sense for the IMF, what will not work, and give us your reasons.

Mr. SOLOMON. I assure you, Mr. Chairman, I will make every effort to be as broadminded in this as possible, in trying to work with the subcommittee.

Chairman NEAL. But it is a serious concern, and it is a concern that is voiced to us many times.

Thank you, Mr. Solomon. Mr. Leach.

Mr. LEACH. I am taken by the rather pessimistic view of the world you have presented to us. Let me read two sentences. "The prospects for the world's economy in the new decade are stark and sobering." Then you say, "We are entering a period of strained danger and financial uncertainty."

It strikes me that the IMF obviously has a role for countries in balance-of-payments difficulties, but also for banks in lending difficulties, and that in a sense the IMF bails out both countries and banks. What is your assessment of the problems U.S. international banks would face, if we don't go forward with this particular legislation?

Mr. SOLOMON. That would be impossible, Mr. Leach, for me to make that kind of assessment. I think that the result of this would be that all banks would retrench even more than they otherwise would. We think the banks will be more cautious this year anyway, in their international borrowing and lending, because we have had a few years in which many countries have been borrowing to the hilt. We think that the recycling problem through private markets is still doable in 1980, but I am not sure what the situation will be let's say in 1982, if these huge OPEC surpluses continue, but if the IMF were not to receive renewed resources, this would be seen as an expression of a lack of confidence, in the IMF. The effect would be one of causing more banks to exercise even greater retrenchment and caution in their new lending.

I do not believe that this would cause significant defaults, although one cannot be sure about it. It is a very serious situation which we discussed a bit last year. I remember Mr. Cavanaugh was interested in this issue as well.

What happens actually when a country adopts an IMF program, and looks as though it will implement it, even over a 2- to 3-year period, the private lenders have more confidence, and normally the pattern has been that banks increae their lending, because they feel the country will be following sounder economic policies. So I don't think that it is appropriate to say that IMF financing is a bailout. The IMF strengthens the international monetary system

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and the international capital markets, because its financing leverage, enables it to help bring about the basic changes and policies that are essential to maintenance of good credit. I think that is really its most important role.

Now typically, of course, some countries would rather borrow in the private markets without having to make painful political decisions about changing economic policies. We have seen this time after time after time, and of course one of the problems is they don't come to the IMF early enough to permit a less painful adjustment, instead they run 5 or 6 years of printing money and large balance-of-payments deficits.

They borrow to the hilt. They use up all their reserves. The economy is beginning to come to a grinding halt. Production is falling. Incomes are falling. Everybody is in very great and serious danger. Then they come to the Fund and then they say, "Oh, the Fund imposes too tough a medicine." It is a little bit like blaming the doctor because you are sick when in fact you have delayed in getting the right medical attention.

Mr. LEACH. Do you think that if banks had imposed upon them capital ratios and/or with reserve requirements in their Euromarkets operations, they would then be in a position of having to refuse to recycle some of these enormous petrodollar surpluses and therefore the Fund would be the only alternative?

To put it another way, do you feel we have reached the point where we just simply have to start restricting the banks in order to encourage movement toward the Fund?

Mr. SOLOMON. I think the major reason for the Fed's proposal on uniform minimum reserve requirements is not to try and bring about an overall reduction in the volume of recycling. It is, first of all, an attempt to eliminate the competitive advantage that the offshore markets have compared to onshore, and in that way tend to slow down somewhat the incredibly rapid growth of the offshore markets, a development which complicates somewhat our management of domestic monetary policy. That was and is a primary objective of ours in engaging in these talks with other central banks.

As you know, Mr. Leach, no agreement has been reached. Some countries do not impose reserve requirements, and would prefer to think in terms of capital ratios.

I don't think, however, that, one should think of that exercise as being designed to reduce the volume. There may be some incidental impact on the volume of international borrowing and lending, but it would be more likely, I would think, that at the margin there would be some shift back to onshore lending.

Mr. LEACH. One of the subjects getting greater attention these days is the concept of a substitution account. If we imposed capital ratios or reserve requirements which would effectively lessen the ability of an individual bank, and thus collectively all the banks, to accept potential deposits, and consequently potential loans, you would thereby force the OPEC countries to really search for another place to put their surplus funds, in other words, into a substitution account.

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You are not tying the two together, but let me just ask whether in your judgment the ongoing negotiations appear likely to be fruitful in establishing a substitution account?

Would you be sympathetic to straightforward legislation authorizing U.S. participation in a substitution account?

Mr. SOLOMON. The discussions are making progress, but they still have a long way to go. I think the main issue to be resolved is that if there were a shortfall, either in the cash situation in the substitution account, or in the bookkeeping, net worth situation in the substitution account, how would that shortfall be made up?

The United States has made it very clear that we are not prepared to take on any special contributions, although we are prepared to share equitably in whatever burdens may be appropriate. This substitution account has to be recognized as in the common good, and therefore in everybody's interests, as it strengthens the monetary system, and gives direction to the evolution of the monetary system.

Therefore, there has been some increasing discussion among member countries in the IMF about using part of the IMF gold as backstopping for the substitution account, in case there is a shortfall. The particular modalities of the way in which that would be done are only in their initial discussions. You could either sell part of it or you could simply carry it in the asset column of the substitution account at whatever value was necessary to bring the account into balance, or not even carry it in the balance sheet, but just have a footnote on the bottom that there are so many ounces of gold.

This does not in any way represent a monetization of gold. It just recognizes the storehouse value of gold.

I think that if there were to be a consensus, which needs an 85-percent majority, on the use of some of the IMF gold for backstopping that, this would be a very major step forward in bridging that gap between what quite frankly we are prepared to do and what the viable substitution account needs. It would represent an expression by all IMF members that this is an appropriate use.

Now I think that is all I can say at this point, and I have no way of knowing whether there will be a sufficient consensus. I think there is a consensus on the principle of using part of the IMF gold, but I am sure that there will be vigorous differences of opinion on the particular modalities. It will take time, of course, time to work through all the technical aspects of that.

I would not suggest the administration proposing legislation until we can give you an exact blueprint as to what has been agreed upon. I am sure that we would come to the Congress at that time and ask for the necessary legislative authority. On an unofficial basis, we will be pleased to keep you informed of the progress of the negotiations. We do not need an actual hearing for that each time but we can keep you informed so that you can give us your reactions as we go along.

So I think it is a little premature to say whether legislation will be required because we do not know whether there will be a successful agreement on all the dotting the "i's"and crossing the "t's." It is a very complicated set of factors to get into full working order and have an 85-percent agreement on in the fund.

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Mr. LEACH. I do not want to draw this out. But I am convinced that the substitution account is possibly the most important agenda item in international finance today and I would be strongly supportive of your moving in that direction as rapidly as possible.

While one hesitates to say that part of the rationale for such an account is lessening the risk for the international banks, I think that should be a serious objective at this time. It is difficult not to believe that banks are overextended and that a substitution account would be one way to recycle petrodollars without relying on a very few private institutions and at the same time make governments somewhat more dependent upon an international institution which has some capacity to invoke necessary domestic monetary and fiscal policy changes.

Chairman NEAL. Mr. Cavanaugh.

Mr. CAVANAUGH. Thank you, Mr. Chairman.

Congratulations on your—are congratulations in order to move to the Federal?

Mr. SOLOMON. I hope so.

Mr. LEACH. Will the gentleman yield?

Perhaps there is a second job available up there, Mr. Cavanaugh. Not every Member is seeking reelection.

Mr. CAVANAUGH. I am going to Nebraska, though. But you would be welcome when you are finished with the Federal to join me.

Mr. SOLOMON. I would like to meet with you privately and find out why you decided not to stay in the Congress. You were developing a pretty deep expertise in this area and it is a fairly technical area. It is always a problem, I must say, looking at it very selfishly from our point of view, that we go through a learning period with the members of the committee and then they decide not to stay in the Congress. I have the excuse at least that I am going to be staying in the monetary area, although I will be changing the particular job.

Mr. CAVANAUGH. I am going to stay in the law, I am just going on the right side of it.

Mr. SOLOMON. OK.

Mr. CAVANAUGH. I do want to continue our discussion that we have had over a number of years. It does seem, though, those discussions between the Congress and the Treasury and our representatives to the Federal have had some impact. But I think that there remains a large gulf between the views of what is possible and appropriate as we address the issue of international financing and international economic readjustment.

You raised many of those same issues again. While it appears that the level of sensitivity has been raised, as I read through your statement I still come to a discouraging conclusion that while some of the rhetoric has been adopted, much of the substance has not in terms of what is the best policy approach in dealing with the economic problems, primarily of the less developed countries.

You continually make the distinction between imposing economic conditions and requiring social conditions. I think that at the heart of the idea here is, how do you define economic conditionality, antiseptic of social consequences?

Mr. SOLOMON. I think the way I would formulate our view of the appropriate IMF function is that it confine itself to setting the

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broad macroeconomic targets in consultation with the Government that are absolutely essential to economic recovery; for example, the size of a public sector deficit. But the Fund should not advise or initiate any discussions as to the particular way in which to do it.

It is up to the Government. If the Government wishes to maintain subsidized food prices but increase taxes, that is purely a national sovereign decision. The IMF would have absolutely no difficulty with that.

But for the IMF to say that this or that way is the way for changing your system of taxation, for example, in order to achieve a different distributional burden, would be considered I think a very inappropriate intervention.

Now it is perfectly possible for the IMF to say that your taxation collection system could obviously stand substantial improvement and they will give technical advice on many areas such as that, if called upon. But for them to say that you should do it one way rather than another to reduce, let's say the public sector deficit from x percent of GNP to y percent of GNP, gets you into a difficult area, Mr. Cavanaugh. I do not know what the solution is. You have 140-odd countries and they have their own differing social and cultural and internal political priorities and I think that there is a line to be drawn, if you want the IMF to be a viable institution.

What would you ask them to say in the case of the Unitod States? Suppose we have to go into a credit tranche. Although we have drawn about 24 times, so far we have been able to confine our drawings to our reserve position. But supposing we went into a credit tranche, God forbid, and the Fund said to us that you are printing too much money to finance a ridiculous budgetary deficit and an adjustment program over 2 or 3 years would require bringing it down to x percent of GNP. They would ask us, how do you propose to do it?

After consultation with the country and with the Congress we would tell them how we propose to do it. But I do not think we would accept them telling us that we have to cut back on certain domestic programs and change other programs and get into that kind of micro thing.

Mr. CAVANAUGH. You have often turned it back on the United States. I think that I have observed that argument made by you in every instance. And frankly, it does not offend me. I do not see it as a violation of sovereignty.

If you are going to accept the concept of an international lender and an international public lender, I think that all who approach that public lender then have to, obviously, acquiesce in the policies of that lending institution, no different than the lending criteria of a private institution.

Chairman NEAL. Will the gentleman yield?

Mr. CAVANAUGH. I would like to finish this point if I can.

Chairman NEAL. All right. I have something on this very point.

Mr. CAVANAUGH. And you cannot—you mislead, I think, yourself and the world community and it seems that we disserve the cause of international economic stability when we try to say to the borrowers or try to say to ourselves that these economic trauma that first give rise to the need for the institution and the lending and

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the borrowing, that these economic trauma do not have socio and political consequences and that their remedy is going to be accomplished without social and political consequences; and further, that their is not any coherent logic or policy that can be applied to them.

In fact, we have applied a coherent and consistent logic and policy in the administration of the IMF in terms of social and economic policies by what we tolerate, you ratify and you in fact support and sustain by providing the economic viability for those social and political policies to be continued.

The case that we had with Nicaragua, late in the Somoza regime, where I met with Mr. Cross, we were at that time supporting an additional lending to the Somoza regime, in the last 30 days I believe it was. Clearly the economic difficulty of that regime was the capital outflows that the country was experiencing. The root cause of the capital outflows was the regime itself, was Somoza.

To contribute to making up the difference or to sustaining or compensating the Somoza regime for those capital outflows for which his policies and his very political existence was the cause, is to ignore the economic reality there, to ignore the underlying economic fact. That is only the most extreme kind of case. But each case and each country, the policies that the country adopts, whether it is our own or not, have real economic consequences. You cannot ignore them.

How much is spent on defense determines the economic health and vitality of that country and its prospect for success.

Mr. SOLOMON. I think you are absolutely right, that these interact, the economic and the political and the social decisions. But let me make a few points to you.

First of all, we already have a problem that countries do not come to the IMF early enough and then the adjustment is incredibly painful the longer they wait. If, in addition to imposing tough economic conditions, you are going to ask the IMF to impose particular domestic priorities in regard to, let's say, social spending versus defense spending, then you are making it even tougher on the country and thus weakening the system of adjustment.

Mr. CAVANAUGH. Could I make a refinement right there?

I do not go the whole direction that Congressman Harkin does, I do not say that the IMF ought to be a social service agency or supplementing the social needs of the Nation directly, but I do say that it ought to be a hardheaded economic system appreciative of all of the factors.

What I think the great failure has been is that the IMF views itself as a hardheaded banker that could only view these broad macroeconomic criteria, and that is a delusion and it in fact is not—does not give rise to sound judgments, because those factors exist, they impact upon the success or failure that any lending is going to facilitate. And if they are not addressed in the criteria, you cannot expect to have an international economic fabric that is coherent, understandable, let alone just.

Mr. SOLOMON. In general, conceptually, you certainly have a point. But look at the realities of life as it is practiced in the world today. Suppose for example, that Pakistan had come to the IMF a year ago and the IMF had said, you should cut your defense spend-

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ing. Then comes the Soviet invasion of Afghanistan and everybody would be saying, that stupid IMF, it was entering into areas that it should not have entered into. It had no right to enter into it. Pakistan now has even less ability to defend itself, for example, because of the IMF. I am just using this as an illustration which is current.

The IMF is not God, nobody will let it be God, and it does not have the wisdom to be God.

If it is going to be a viable institution and discharge its main function, I think that there are limits to the areas that it can get into. Now that does not mean that it should be insensitive to the social and domestic, I use the word "political" but in the broad sense of the word "political," not in a narrow partisan sense, objectives of the particular country. And it is up to that country to be encouraged by the IMF. To the extent that such factors can be incorporated in the basic adjustment program, they should.

Now, Mr. Cross has made statements in the IMF Executive Board, and has had consultations with the Managing Director and with other Executive Directors ever since we got into this discussion in connection with the passage of the supplemental financing facility. And Mr. de Larosière the new IMF Managing Director, has made some important policy statements in that regard.

I do not know whether you have a copy of those or not but we will get them to you.

Mr. CAVANAUGH. I am gratified with the improvement. I think we have made significant improvement.

Mr. SOLOMON. In the real difficult cases, take, for example Turkey. Given the incredibly difficult situation Turkey got itself into by not taking adjustment policies earlier, the IMF has leaned over backwards to try to work out a more gradual adjustment program. And I honestly believe there has been a very noticeable increase in the awareness, and sensitivity to these issues by the IMF staff and Managing Director. And I think that this is probably more due to the congressional view transmitted through the U.S. Executive Director than to any other factor, although Mr. de Larosiére came to the job with his own views on this, which I think tracked quite closely those that we have heard expressed in these Halls.

But there are limits, and in some respects the Harkin amendment goes beyond the limits that would be feasible if the IMF is to continue as a viable institution, working toward its chief objective. But there may not be in specific cases as much of a gulf between you and me, and I think you are a practical person and would recognize the limitations and where the IMF has gone as far as it can.

Mr. CAVANAUGH. I do not think I am as practical as you are. But I do appreciate the progress that has been made.

Chairman NEAL. Mr. Lundine.

Mr. LUNDINE. Thank you, Mr. Chairman.

I apologize for being late. I hope that I will not be redundant. In fact, I would like to follow up on some of the questions or dialog that has just been occurring with Mr. Cavanaugh.

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You indicate that their's clearly is a level of inappropriate intervention by the IMF and that there are limits on the area—however, that there are limits on the areas that they are to get into.

I guess in general none of us could disagree with that, nor disagree with your statement of that portion starting on page 8 where you indicate that the IMF is criticized on the one hand for being a form of foreign aid and, on the other hand, having such strict conditionality that it is actually repressive. But I am getting increasing reports—some of which I intend to try to verify through independent investigation, come to grips with—that throughout the Third World the IMF is in fact viewed as an instrument of repression and that its conditionality, not only in terms of the number of years given to rectify situations but in terms of the actual conditions themselves and their predictable impact on various strata of society of participating countries, are increasingly harsh.

Now you point out that you believe that the new guidelines should help dispel the idea that conditionality is a weapon for imposing unnecessary hardship. I certainly hope so. And I realize fully the difference in the purposes of these institutions but it seems that the World Bank, for example, has a somewhat different approach and somewhat different reputation in some of these countries than does the IMF.

I just want to ask you whether, beyond these guidelines, there is anything that the United States can do to assure that at least we are not an instrument of imposing a greater proportion of hardship and sacrifice on the poor in these countries than we are on people in these countries who are actually profiting by the stabilization program, that is to say those with substantial means?

Mr. SOLOMON. Let me make two comments, Mr. Lundine.

It is not only the Third World countries who have criticized the IMF. I remember when the Prime Minister of Great Britain, the Prime Minister of Italy, and the President of Mexico all said that the IMF program was harsh and that there had been great difficulty in reaching agreement because the IMF conditions were extremely harsh.

After the successful adjustment that occurred in each of those three countries, each of those three gentlemen publicly said that in hindsight they felt that the IMF program had been a great contribution and they were extremely pleased with the turn in their economies. The IMF is often a very useful whipping boy when a country has to take painful measures because it has delayed so long.

Now you asked me if there is anything further we could do to meet this criticism that the IMF is harsh? One thing occurs to my mind which might have an impact.

If the IMF had the resources to make its loans available at very, very low interest rates—I am speaking now personally but I think that this is probably true—it may be that you could get countries to come to the IMF earlier. Now I am not sure there would be a big difference because from a politician's point of view it is not the difference in the interest rates that is going to attract him, it is really the political unpalatability of taking these measures, of cutting the budget deficit, and stopping the central bank from printing so much money.

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But it is possible that if you could offer extremely low interest rates in the IMF, and you should offer them to both developed and developing countries, because all members are treated equally, then it is possible that some countries would come somewhat earlier to the IMF. The earlier they come, the less painful, the less harsh is the program that is needed. This is the key factor.

So the name of the game is, how do you get them in early? The ultimate objective, is adjusting sufficiently so that you can resume sound economic growth and increase everybody's real standard of living, that has to be the same. But how do you get them in earlier?

Aside from—if you get them in by easing the conditionality to a point where you do not achieve the adjustment, and therefore resume sound economic growth and improve standards of living, then why have the institution in the first place? It is not achieving its objective.

Mr. CAVANAUGH. Right.

Mr. SOLOMON. So I do not really know.

What we have done, is to lengthen the period of adjustment so that it would not be as harsh a program. In other words, instead of requiring an adjustment program in 1 year, it now is more typically 2 or 3 years. We have also lengthened the repayment terms. The interest rates that they pay are lower than present international borrowing rates in the markets.

I think it is probably a question of some reasonable degree of statesmanship required by national political leaders to come to the IMF earlier when the size of the adjustment problem will not be as big.

But you really build world opinion and influence political decisionmaking on the part of heads of governments so that they are willing to bite the smaller bullet more quickly? That would depend always I guess on the way the people in charge in a particular government see to their own political advantage.

Mr. LUNDINE. Also, it will depend on the way the IMF is run.

I just want to make one point here.

I am not criticizing the IMF for being harsh. I make an analogy within our own country to the city of New York. I think that kind of assistance from the Federal Government ought to be harsh, it ought to be very difficult, painful, so that another city does not want to come in.

But the way that that program was worked out, I think it was rather difficult, harsh, if someone wanted to use that word. It did not fall on the backs of some people worse than others, necessarily. And I think the difference between Britain, Italy and what did you use, Mexico as a third case, two of those three countries got enormous oil resources. I think you are talking about somewhat different situations in those countries, two out of the three at least, highly industrialized, than you are in the case of some of the countries that I was trying to refer to. And I am not criticizing it for being harsh. I guess the IMF has to be prudent, as tough as it is prudent to be to assure that loans are repaid and, as you point out, that the stabilization program is successful.

What I am concerned about is if the IMF is putting conditionality on what clearly falls heavier on one part of the population in

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that country, regardless of political decisions by that country, than on others. As I understand it, you do not believe that is occurring?

Mr. SOLOMON. I think it is quite clear that under the guidelines now the IMF will not take the responsibility for advising on how to reduce, for example, the budgetary deficit, because cutting the public sector deficit usually results in the kinds of situations you are referring to. Because, let's say, in most of these countries there are State-owned enterprises running large deficits which add to the regular budget deficit. So you have a large public sector deficit sometimes arising food subsidies but frequently from other causes. Frequently it is simply a large State-owned factory producing non-food products, inefficient, running at a loss, and it is politically difficult to raise prices or to rationalize production.

I do not think that the IMF is now in any way suggesting particular ways of reducing the budgetary deficit, although it may provide technical assistance

I honestly believe that the IMF staff is trying to avoid imposing the kinds of conditions which would bear a heavier burden on one part of the population rather than another. But I think that the point of the Harkin amendment is to go beyond that; namely, that it would like to see the IMF not simply putting the broad macrotargets that are absolutely essential to adjustment, but it would like the IMF to propose ways in which this can be done, which puts the burden of adjustment on those segments of the population more able to bear it.

Now in practice—first of all, as I have said earlier, I do not think that national governments will permit the IMF to intrude to that degree.

And second, I think that when you have an overall economy that is in a bad situation, any adjustment is going to bear heavily on all segments.

Take the United States, we are the richest country in the world and if we were to really, ruthlessly decide we were going to eliminate entirely our public sector for deficit and follow very, very austere policies, I do not know how the Congress would attempt to distribute that burden. It would have to take into consideration defense considerations, and social priorities; it would have to take into consideration productivity considerations as far as new capital investment by business. It is an extremely difficult job and it varies from country to country. It would be a mix of what is politically possible, economically sound and socially desirable. And I do not think it is possible for an international institution to make those decisions.

But it certainly should avoid, advice which makes the conditionality bear heavier on one segment of the population than the other.

Mr. LUNDINE. Well, I thank you, Mr. Chairman.

I would just like to note that over a period of time it has been—I congratulate the Secretary for his outstanding representation of the U.S. interests and higher interests. It may be that I am not able to articulate my questions so that we come together completely in this particular dialog, but I appreciate your tolerance in terms of time and I have appreciated Secretary Solomon's service over the period of time I have had the opportunity of serving on this subcommittee.

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Mr. SOLOMON. Thank you.

Chairman NEAL. I wanted to raise one point if I could regarding the same subject.

It seems to me that if we were drawing from a credit tranche with the IMF and the IMF looked at our whole picture and said, as many have said in criticism of the IMF relationship to Peru, that the IMF should have told Peru to reduce its defense budget and they refused to do it; it would be very much like the IMF coming to us and telling us, in these times, to reduce our defense budget or they would not make a loan to us.

I do not think the Congress would stand still for that for a moment. Well, one Member might, but the overwhelming majority of the Congress would not stand still for a minute for the proposition that the very important policies of this country would be decided by some outside influence for whatever purpose, I wonder, though, if it might not be possible for the IMF in some ways to work more closely with the World Bank.

The criticisms that come, that are directed at the IMF, are most often that it does not do enough for the poor people in a country and that the burden is borne unfavorably by the poorer segments of the country, but helping the poorer segments is primarily a function of the World Bank and organizations like it. Instead of turning the IMF into an aid institution, which it is not, it has never been, I am just wondering if there might be some possibility of it working more closely with its sister organization to coordinate some increased aid from a number of countries with an IMF standby arrangement?

Mr. SOLOMON. I think that in the case where the World Bank particularly heads a lending consortium, that there is very close coordination. There probably is less where it does not head a lending consortium. But the ultimate problem, Mr. Chairman, is that you can see the World Bank money because it goes for particular projects. So you can see when it builds a dam or you can see when it finances a housing project or a rural development project.

The balance-of-payments money cannot be seen, but it is vital because it permits the financing——

Chairman NEAL. That is not my point. My point is that if there were better coordination it might be that a government could at the same time announce a standby arrangement and also some aid to help those that are hardest hit by the necessary belt-tightening that would occur.

Mr. SOLOMON. I think that is an interesting suggestion.

Chairman NEAL. Especially in categories that are—I would think if it has any merit it might be applied to a number of countries, but I especially think of countries like Turkey that are so strategically important.

Mr. SOLOMON. Right. We certainly recognize that there is a need for development assistance, for aid to Turkey.

The OECD is heading that effort and the World Bank is playing a role. As you know we have proposed this year that, in addition to IMF resources, there be multilateral assistance from various countries, including the United States, because the Turks let the situation go on so long that they are in very serious trouble. Essential imports include both food and a certain amount of oil and they

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include raw materials so factories will run and people will have jobs. But it may be that in some way it would be hard to coordinate the timing of the flow of projects coming onstream in the World Bank with IMF standby programs.

Chairman NEAL. You can see how it would take some of the pressure off the IMF. The IMF, it appears to me, gets most of its bad reputation from the countries it helps the most, because governments of those countries do not want to take the blame for doing what is done so they blame the IMF.

Mr. CAVANAUGH. If I could react just a bit because I think some of the things I have advocated here are not appropriately articulated by your understanding of them.

First of all, I think if the United States or any country gets itself into the economic condition that it must go to the multinational lender, then it has to assume that there are going to be some consequences and unquestionably the best, the ideal way of determining how best to confront those economic conditions and make those adjustments within any national system is by the ruling, existing political order presuming that the ruling is both reasonably competent and reasonably well-directed in terms of sound economic principles. That is basically what I have been arguing for here.

What I have been saying is that the proportion, the complexion of the public expenditures within a nation's system, its trade policies and its taxing policies, are all real economic facts to be evaluated with as much objectivity as is possible. The fact is that most of the countries who have gotten in trouble and those that you say complain the loudest are the ones that have received the greatest assistance, and are also the ones that have in general been most misused both by their governments and by their lenders.

Take a situation like Peru where the government's primary policy is its own political perpetuation, to create a military complex that assures that goal, that has an economic consequence, an adverse economic consequence, one that should be judged when the impact of that economic consequence comes to roost in the international arena.

One of the major contributors to that consequence has been those who have lent for those economically inappropriate reasons. And again, when you come to the international forum, some judgment should be passed upon that, some sound economic judgment that is clearly going to have political consequences, but the lender, and particularly the public policy international lender, should certainly be able to say: Look, you got into this situation because of bad public policy, bad economic public policy within your country, exemplified by these actions and by intemperate borrowing and intemperate lending by those who finance them.

Now the whole consequence of that should not now fall on your poor population. And you have to embark upon a restructuring of your economic public policy judgments within your country that is designed, first of all, to remedy the excesses that you engaged in and that caused you this problem, and also to distribute it in a way that is not unfair within your own population, unfair in economic terms.

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And I have consistenly tried to address all of these issues on that high level that the IMF says it wants to maintain of practicing good economics. I think that that is right. That is the appropriate plan for the IMF to operate on. But the IMF is not honestly and legitimately operating on that plan when it does not observe, take cognizance of all of the real factors that go into creating the economical condition and circumstance to which they are addressing their lending. And to say that some of these things are so sociological in their impact, some of these things are political in their impact and therefore we cannot observe them, is not an honest economic judgment. To not observe them will have an economic consequence as well as to observe them.

The only thing that I have argued for in this whole discussion for 3 years is for them to appropriately observe and make the best objective judgment that they can on the whole spectrum of both the causes of the difficulty to which they arrive at the IMF for conditional lending and to have the conditionality be an appropriate address to that whole complexity, and not to say there are certain segments of it that are just too domestic and too political.

I think that is a gross misstatement of the reality that has to be confronted.

Mr. SOLOMON. I think you are right and I believe—but I would like to check with Mr. Cross—that when they do go into a country to analyze the economic situation and why they are in so much trouble, I think they do point out why they are in that trouble and how they got into that trouble.

But what I said, where I drew the line was when it came to recommending policy initiatives, as to how they should get out of the trouble, that there were limits to the degree they should get involved in that. But I believe the analysis of how they got into trouble is objective and is detailed.

Let me ask Mr. Cross.

Mr. CROSS. Certainly that is quite true. There is a lot of discussion in this, consultation, surveillance. Part of the process of the Fund's association with members is to discuss their situation and what is causing the problems that are developing.

But where the countries draw the line is in saying that as a condition to receiving some financing, you can tell us that we have to adjust our budget, we have to eliminate our balance-of-payments deficit, but you cannot tell us that you condition the provision on the financing to cutting this particular expenditure as opposed to that particular expenditure.

Countries are very unwilling to delegate what they regard as the sovereign decision over such matters to international institutions, but there is a lot of discussion throughout the process of what caused this problem.

Mr. SOLOMON. I would like to make one last comment, Mr. Chairman, with regard to something Mr. Lundine said, to point out, it is probably apparent to all of you anyway, but I would like to point out that if the Fund were to go as far as, for example, Congressman Harkin would like, then the complaints that Mr. Lundine has referred to, that these countries make about harsh programs and intervention by the IMF and intervening in their internal matters, would, of course, be even stronger.

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I am not making a comment now at this point on anything other than that these are two separate problems. The complaints of harshness and intervention are not solved by the desire of Mr. Harkin and possibly Mr. Cavanaugh—although there is a difference between Mr Cavanaugh's position and Mr. Harkin's—to emphasize more the social objectives and the humanitarian objectives.

One has to recognize that there are two different problems and the solution toward one increases the other complaint that we traditionally hear from countries who do have to resort to the IMF. It is worth recognizing I think that it is not really the same question.

Chairman NEAL. Mr. Evans.

Mr. EVANS. I have no questions, Mr. Chairman.

Chairman NEAL. Thank you.

It seems to me that your analogy of how we might react is also important. If we had to go through a credit crunch and the IMF started talking to us and the IMF was following the Harkin's thrust, I guess they would have to check with Mr. Kennedy to see if he thought that the policies of the President were those that were best suited to helping all of the people. Mr. Kennedy, I assume would tell him no, that they are not, that we needed wage and price controls, a whole range of other remedies.

Then I guess they would have to check with the Republican side. They would say no, we need to decontrol oil immediately and beef up our military budget some more.

How would the IMF decide on a question like this? I guess it would use its own judgment which it would substitute for that of the Congress. I do not see why we would ask other countries to do something that we clearly would not begin to do in our own country.

Mr. CAVANAUGH. Mr. Chairman, you are talking about a lender and a borrower situation and you are talking about, in addition to that, not a private lender and borrower situation where you have some valid evaluation, but you are talking about a public international lender who presumably has a multiplicity of goals, the first being perpetuation of international economic stability and then, acknowledging that to be its goal, that you have to maintain the health and vitality of the various particulars in order to have a healthy and stable interreaction among all of them.

But it has to make economic judgments, and it would have to make them about the United States. It would have to analyze the problem if you are going to be a lender, analyze the situation of your borrower, determine and make a judgment on what conditions gave rise to his need for supplemental credit, and we are talking about a situation where the normal economics are not justifiable, defensible, there has been a breakdown, a deficiency, otherwise you would not even be in the circumstances that you are.

You cannot simply say, well, it is broken down, we are going to give you the money and hope you fix it. And that is not in fact what happens. They do make judgments, but the way it currently works is, the basic political judgment that is made, that we will not scrutinize the political complexion of any of these decisions, regardless of their economic consequences. And it reduces itself to an absurdity, at worst.

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But what we have observed, and I am not sure that I agree that to comply with this kind of a policy approach would create harsher, less acceptable and more repressive kinds of conditionality and the countries would rebel against it. I think they rebel often against the injustice of the conditionality, more the inappropriateness of the conditionality.

Mr. Chairman, before we go, I want to say one thing, that I clearly have been disturbed by—for a period of time and I have never had the opportunity to ask this question, and I would like to ask it: Are there cases—and you indicate many more countries now in NTA as a result of the new and perpetual oil increases, energy increases, and growing OPEC surpluses, that many countries, more countries are going to find themselves excessively burdened and that the private lenders are going to continue to have to carry the brunt of that burden?

Are there instances that you are aware of in which the better policy would be to allow defaults and those private lendings, on private lendings that were imprudent, that were excessive given the reasonable capabilities of the population to repay them?

Because it seems to me that in those instances where imprudent and excessive lending has taken place that we are condemning innocent populations now who did not, first of all, derive the benefit of the initial extension of capital, but now as that private lending spreads itself off in order to sustain it, into national lending through the IMF and the conditionality imposed upon that and the general depreciation of the whole economy, all of this occurring in large extent in order to assure the repayment of this debt, are there not cases or are their cases or are there going to be cases in which it would be most economically efficient and more economically justifiable to allow defaults in those instances?

Mr. SOLOMON. I definitely agree with that. There have been a few cases where debt rescheduling has been the answer to a default situation, both by private creditors and official creditors. Sometimes the rescheduling is done without an IMF standby, other times it is done with an IMF standby. In any case, the IMF does not play a major role in the rescheduling process. When a country gets into a situation, like Turkey, where it needs to stretch out payments to both official and private creditors, we do insist on comparability.

In addition, countries sometimes need both the change in policies and IMF financial assistance.

You know, this goes back, when I was doing the first big program loans in Latin America, back in the Alliance for Progress, I made it a condition that those countries ask for multilateral debt rescheduling because we did not want U.S. aid to be used indirectly to service debts of other countries and creditors generally.

There are situations where a country can turn itself around without the need for a debt rescheduling, but there are many cases where a debt rescheduling is very appropriate. So I would agree with that as a general proposition.

Mr. CAVANAUGH. I did not mean rescheduling, I meant default. Are there cases where default is appropriate?

Mr. SOLOMON. Complete default? I think that would probably be very shortsighted, because what country can today operate in

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today's financial environment if it has absolutely no credit standing? Even in domestic bankruptcy, there is reorganization. And there is as much payment as possible.

The name of the game of course in a debt rescheduling is to stretch the debt servicing out long enough so that it is within the country's capabilities. But to cut themselves off forever and a day by repudiation of their foreign debts, which in effect that kind of a default would be——

Mr. CAVANAUGH. Is it not another way of stating, a harsher way of stating the rescheduling situation, is that it is to protect the lender at all costs?

The point I was trying to make is, given the tremendous levels of debt that many countries now are carrying, to make it immutable international economic policy that the lender will never lose the value of its bargain, regardless of the erroneousness of the lending judgment originally, is ultimately economically very inefficient, and in terms of the consequences on poor countries and the train of consequences that occur in order to assure that that bad loan, that initial bad loan is never extinguished but is always redeemed, means that these populations have to carry that burden for a very long period of time.

My question is, Is that economically efficient, fair, or just, for us to have created that system and to maintain it now?

Mr. SOLOMON. I think if the situation were extreme enough, the country might very well have to have a debt rescheduling which, in effect, involves a standstill on any payments for a period of time.

Mr. CAVANAUGH. Why not let them default? If it was a bad loan, the resources are not there, why should not the borrower suffer the consequences of that as in any other situation?

Mr. SOLOMON. There is no reason why not. I am saying from the point of view of the borrowing countries they would not want I think to put themselves into a situation where there was that kind of repudiation, because ultimately they are going to require foreign financing. There is no way of operating in the world for most countries without requiring the use of import credits.

Mr. CAVANAUGH. That is because we have created an international policy that maintains that psychology.

Mr. SOLOMON. We do not do that. The creditors would never lend again. Would you permit Eximbank to continue lending unless there were very unusual circumstances involved, would you permit Eximbank to continue lending to a country that repudiated its debt to Eximbank?

You would permit a debt rescheduling if a country were unable to pay, maybe even permit a complete standstill on payments for 1, 2, 3, or 4 years, but would the Congress feel that it was appropriate use of Eximbank credit to continue lending to a country that said we have no intention of paying in the future even if our economic situation improved?

It is not a question of government policy, it is just that creditors obviously will not lend if they think there is no willingness to resume payments at some point in the future. I do not think creditors would be willing to ever lend to that country again.

Chairman NEAL. The gentleman left the impression with me anyway that there is some kind of international organization that

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assures that banks will not lose any of the money they lend in the international arena. I am not aware of that.

Mr. CAVANAUGH. Effectively that is what we have created.

Chairman NEAL. Where?

Mr. CAVANAUGH. In the IMF.

Mr. SOLOMON. But there are a lot of debt reschedulings, Mr. Cavanaugh, without the IMF being involved. You are aware of that.

Mr. CAVANAUGH. Unquestionably, but the IMF is a safety net, as one of the facilities was described, for that international commercial banking system, so even in those instances where it is not employed, it is understood that it is potentially viable, and the fact is that our recent history has been that in any instance in which serious default is precipitous, the IMF then moves in. Those are the conditions under which the IMF does move in, when a country is no longer able to finance itself through the private markets.

Chairman NEAL. But because of specific reasons, balance-of-payments problems, isn't that correct?

Is there any consideration of standby arrangements most specifically that would give banks a beneficial position? Is there any implication of that whatsoever?

Mr. SOLOMON. The IMF does not come into a situation simply because a country has large external debt, and has difficulty carrying it. The IMF comes into a situation when the country asks.

There is an adjustment program to correct its balance-of-payments problem. Incidental to that, you may either have a debt rescheduling depending on the size of the problem or you may not, but the debt factor or the paying off of a private bank is not the objective.

Mr. Cavanaugh is right in that there are obviously incidental implications in regard to a situation of the creditors. Sometimes they will be asked to reschedule, because the problem is too large, but let's say a country were to come in early in the game, and obtain an IMF standby, it may very well be then that it can right its economic house, and not have to ask for a debt rescheduling.

Now, if you want to call that bailing out the banks, I suppose you can, but I don't think that that is really clear, because there is no real danger of default there. It is not in the interests of a country to default or ask for a debt rescheduling unnecessarily. They really only do it in the last resort and they are usually extremely unhappy about it. The IMF role is really centrally motivated by a different set of circumstances and objectives, although there is some incidental fallout, which may vary from case to case, on the creditor situation.

Mr. CAVANAUGH. But the system we have created, it seems to me, is a system that now protects the bad as well as the good. It protects the bad lender and the bad government from their own intemperate, inappropriate, or even wrongful acts, and excessive indulgence by a government in defense or a single developmental project that was unsound, that subsequently collapsed in its own economic vitality.

But we now have a system that says, even if this was a bad government and a bad lender dealing together, the whole international system will sustain the value of those bargains, and the

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particular population will pay the consequences of those bad judgments, rather than having the culpable parties pay the consequence. You cannot fail in international lending anymore, and you should be able to.

Mr. SOLOMON. Let me make two comments. First of all, there is a price that that country pays, and that is one reason why you get these complaints about harshness of conditionality.

Mr. CAVANAUGH. The innocent population pays the price.

Mr. SOLOMON. Well, the country, the economy pays the price. There is no way of avoiding it, and think what price the innocent population would pay if a country chose to repudiate its debts and shut off forever and a day its source of international credit.

Mr. CAVANAUGH. What is wrong with a system where lenders generally say, "That was obviously a bad deal. That deal shouldn't be sustained, and the population of this country shouldn't be burdened in the totality of their economic consequences. Let that lender take his loss. He made a bad deal"?

Mr. SOLOMON. That sometimes happens. Sometimes lenders lose money. You have had repudiation of foreign debt, as distinct from debt rescheduling.

The Soviets when they came in repudated the czarist debt, and other countries have done the same thing, and ultimately they were able to reestablish credit lines but—it took them many years—by changing the attitude, the psychology of the lenders, and convincing the lenders that repudation was a once-and-for-all, step associated with political revolution and that they would not do it again.

There have been cases where creditors to governments not only get their repayments stretched out through debt rescheduling, but actually ultimately suffer a loss. That happens, and it is not the objective of the U.S. Government or the IMF to conduct their policies in a way which would prevent that from happening. It is the government in question usually, the borrowing government, who feels that it would be irrevocably damaged if it went as far as a complete repudiation.

Mr. CAVANAUGH. I thank you. I have enjoyed our association, and wish you every good luck in the future in the Fed. I read where you are going to be the new gnome. I would expect you to be a giant.

Mr. SOLOMON. In that same article that said I was going to be a gnome, they also said that I looked more like a refugee from a sculpture studio than a banker.

Mr. CAVANAUGH. Which is probably where you prefer to be.

Mr. SOLOMON. Anyway you will have to visit me in New York, all of you, when you are up there. I think this will be my last appearance before this committee and I really wish to express my appreciation.

Mr. CAVANAUGH. Thank you, Mr. Secretary.

Chairman NEAL. One other question, if I can.

In your statement you pointed out that this quota increase would not increase the government's budget deficit, and I just wonder if you could clarify that a little bit in simple terms. It seems to me that if we were to pay out more money than we took in, that that would of necessity increase the deficit.

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Mr. SOLOMON. You are talking of the appropriation treatment. What happens is that there would be a full appropriation. The first 25 percent of the quota increase would be paid for in SDR's, special drawing rights. All countries are going to do that on this increase. When the IMF draws dollars from us, our official monetary reserves automatically increase by the same amount in the form of a reserve position in the IMF.

Now, at the time of the last quota increase, the Congress recognized that this was an exchange of assets, and therefore there was no appropriation required by the Congress. We found in the course of legislating the Witteveen Facility that both the Budget Committees and Appropriations Committees wanted to supervise that operation and we went through the appropriation process.

If this approach is finally adopted, we would go through the appropriation process, but tentatively it is the view of most of the experts in the budget committees that the thing that makes the most sense is that you require full appropriation, but you recognize the fact that the money is flowing from one window of the U.S. Treasury to another window of the U.S. Treasury; the dollars go from the general fund to the official monetary reserves of the U.S. Government.

Putting it more technically, it is an outlay on one side and receipt on the other, so there is no net outlay.

Chairman NEAL. Mr. Secretary, I would certainly like to thank you for coming today, and wish you every success. Mr. Cross and Mr. Leddy, thank you also for coming. Please do give this idea of closer cooperation between the IMF and the world banks some thought and see if there is something that can be worked out here.

Mr. SOLOMON. We will.

Chairman NEAL. And we would welcome any comments you have on the proposed amendents.

Mr. SOLOMON. Thank you, Mr. Chairman.

Chairman NEAL. You may want to follow the hearings as they go along and maybe some other issues that are addressed. The subcommittee stands in adjournment until 9:30 on Wednesday, when we will have a continuation of these hearings.

Thank you very much.

[Whereupon, at 12:10 p.m., the subcommittee adjourned, to reconvene Wednesday, February 6, 1980, at 9:30 a.m.]

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TO AMEND THE BRETTON WOODS AGREEMENTS ACT TO AUTHORIZE CONSENT TO AN INCREASE IN THE U.S. QUOTA IN THE INTERNATIONAL MONETARY FUND

WEDNESDAY, FEBRUARY 6, 1980

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON INTERNATIONAL TRADE,
INVESTMENT AND MONETARY POLICY,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, D.C.

The subcommittee met at 9:40 a.m., in room 2128, Rayburn House Office Building, Hon. Stephen L. Neal (chairman of the subcommittee) presiding.

Present: Representatives Neal, AuCoin, Cavanaugh, Evans, Lundine, Leach, Hyde, and Hansen.

Chairman NEAL. The subcommittee will come to order.

This morning we begin our second day of hearings on the proposed increase in the U.S. quota in the International Monetary Fund.

We have invited our panel of witnesses to address the problem of the impact of IMF policies on less-developed countries. This problem has generated most of the controversy the subcommittee has heard about the IMF over the past few years.

Critics of IMF policies charge the Fund with demanding conditions for credit that are too harsh and that fall too unjustly on the poor segments of society.

In defense of the Fund's policies, it is argued that the IMF can only set out the broad macroeconomic targets the country must meet in order to correct the disequilibrium in its balance of payments.

What specific steps the country takes to meet these broad targets is not for the IMF to decide. Such decisions must remain the political responsibility of the government in power.

It is, for instance, usually necessary for the government to reduce its budget deficit. In most developing economies, the deficit is financed simply by printing money. If the budget deficit cannot be controlled, neither can the growth of the money supply. If money can't be controlled, inflation will get out of hand. With fixed exchange rates, inflation at home will render foreign goods cheaper than domestic goods. So imports will rise, exports will fall.

The demand for goods and services will exceed what the economy can produce. The excessive demand can only be met by increasing

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imports. Simultaneously, exports become more expensive and unprofitable, so they decline.

The trade deficit becomes worse and worse and can be financed only by borrowing more and more from abroad.

Eventually, a country can borrow no more and is forced to turn to the IMF. Then what can the IMF do? It has to say the obvious. The country must take steps to correct its trade deficit.

To do that, it will generally have to reduce its budget deficit and restrain inflation by slowing the rate of monetary expansion.

In some cases, it may have to devalue its exchange rate.

While there are always special situations and circumstances, this mix of budget control, monetary control, and possibly exchange rate devaluation is, often enough, the minimum set of demands that must be made of a country if it is to correct its balance-of-payments deficit.

To be sure, one can argue about the timing of these policies. Should they be stretched out over 1, 2, or 5 years? How quickly should the budget deficit be reduced? How rapidly should monetary expansion be decelerated? How soon should the country be expected to repay its debt?

Clearly, the IMF should be realistic and politically sensitive in structuring destabilization programs, but it cannot backtrack from the fundamental problem. Without some judicious application of these kinds of broad macroeconomic policies, the problem will not be resolved.

If the problem is not resolved, the country could only survive with increasing amounts of foreign aid. But foreign aid on this kind of scale is simply not available.

The country literally has only one choice: It can accept a stabilization program of the kind the IMF would likely recommend, or it can wait until its foreign aid and private international credit dry up and then impose severe restrictions on imports and be forced into other steps which cause economic disaster.

Given the nature of what must be done, given all of the flexibility and gradualness the IMF can reasonably permit, the question arises as to how far the IMF should go in prescribing specific policy steps?

The answer has been that the IMF should only specify the broad targets while leaving the government free to decide how to reach those targets.

It recommends a certain reduction in the budget deficit, for example, and leaves it up to the government concerned to decide what to cut.

Undeniably, governments may decide to cut in ways that seem unjust or unfair. The political ends of some governments are clearly not our own, but realistically speaking, the IMF must recognize national sovereignty and cannot be expected to dictate social and political reform in member countries.

It has quite enough difficulty with the relatively simple task of helping countries overcome severe balance-of-payments deficits.

For the IMF to exist to do the essential job it does as banker to the world, it should not, in my opinion, be turned into an agency of foreign aid.

That would cause its destruction.

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This morning we have a distinguished panel of witnesses to address these questions. In an arbitrary way, we arranged witnesses in alphabetical order and asked that they be heard in that order. And I see the chairman of our full committee has joined us this morning.

Mr. Chairman.

Chairman REUSS. Thank you very much.

I listened to your opening statement with interest and I find no fault with your statement that the IMF has to assure that it isn't simply pouring in good money after bad, and hence, to impose some rather heroic macroeconomic demands on the countries that it has relations with.

However, I want to be sure that the IMF, consistent with that overall don't-dribble-your-money-away precept, has something a little more benign than the traditional banker's glass eye.

And I therefore think it is good that you called this panel to see whether there are not ways in which we could make the IMF executives and loan officers and our own Executive Director and Secretary of the Treasury a little more conscious of the effect on human beings of what they're doing.

If we did that, it might be that there are two ways of reaching the sound macroeconomic banker's goal that they have in mind.

And I would hope that we could induce them, when faced with that choice, to select a way which was least harmful to the human beings in the borrowing countries, whom, after all, it is the purpose of the IMF to help.

That is what it is about.

We did not set up the IMF at Bretton Woods 45 years ago to deal only with arithmetic and not deal with the problems of people who want jobs and reasonable prices, and an opportunity to advance.

So I commend you for having this and let us see what the witnesses have to say.

As you know, I spent some time drafting a proposed amendment to our IMF authorization and it will be very much in my mind as we listen to the witnesses.

Thank you.

Chairman NEAL. Thank you, Mr. Chairman. I certainly share your goal of making this institution, insomuch as we can, an institution that truly helps people.

That is what it is all about.

Are there other members who would like to have opening comments?

[No response.]

Chairman NEAL. I would like to place in the record at this point a statement of our colleague, Congressman Tom Harkin. Without objection, so ordered.

[The statement of Congressman Harkin follows:]

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The International Monetary Fund, Bank Disclosure, and Basic Human Needs

By Representative Tom Harkin (D-IA) For the House Subcommittee on International Trade, Investment and Monetary Policy

January 6, 1980

I appreciate the opportunity of submitting my remarks concerning increased United States participation in the International Monetary Fund. The legislation we consider today -- a $5.6 billion authorization -- is a controversial and serious proposal.

The International Monetary Fund has come under increasing criticism in recent years by the United Nations, by representatives of the Fund itself, and by leaders in our country and abroad for the harsh rigidity of its stabilization programs and for its role in perpetuating Third World debt to private banks.

In determining the extent of United States participation in the IMF, it is vitally important for the Congress to seriously investigate the following questions: What is the economic condition of oil-importing Less Developed Countries (LDC's) and what role has the IMF played in alleviating LDC debt and international economic instability? What are the Fund's standard operating procedures in extending credit to debtor countries? What are the implications of IMF activities on political stability in the Third World? Who are the beneficiaries of IMF transactions and procedures? What are the effects of IMF conditions on the quality of life of the world's poorest people?

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Perhaps the most significant feature of the international financial landscape today is the acceleration of LDC indebtedness. According to the World Bank, the debt burden of developing country governments totalled $253 billion by the end of 1978. Recent UNCTAD estimates project Third World debt reaching $358 billion by the end of 1980. Professor Howard Wachtel of American University describes the phenomenon in this way:

> "Servicing this debt has become a serious problem for foreign-exchange-poor LDC's. UNCTAD estimates that debt service ratios on the average are approaching 25% for the 45 poorest LDC's, where 15% was formerly considered dangerously high. Many countries now have debt service ratios far in excess of 20%: Uruguay 46%, Mexico 26%, Peru above 50%. Furthermore, the massive accumulation of debt since 1974 has barely begun to appear in these statistics. Since this debt is medium term, countries will not begin servicing their mid-1970's debt until 1980 when the debt crunch will really rear its ugly head. And if another inter-national recession occurs, all bets are off for the servicing of LDC debt in many countries."

Many factors can be blamed for the enormous increase in Third World debt. The penetration of the less developed world by multi-national corporate investors and the increased emphasis on export-directed economic policies have left many LDC's at the mercy of the international market place. The prices of irreplaceable imports, such as oil, food commodities and manufactured goods have skyrocketed in recent years. Most important of all, the world recession of 1973-74 obliterated the development gains of the 60's and early 70's in the Third World. In an effort to combat their own balance of payments problems, the developed countries cut back on imports from

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the Third World and promoted exports. Rising protectionism in the developed countries has had a devastating impact on LDCs' balance of payments position.

At the same time that LDC's faced grave capital shortage problems, American banks confronted a different capital problem. The biggest American banks found themselves with some $50 billion in petro-dollar reserves and a depressed loan market in the OECD countries. In their zeal to loan and profit by these enormous deposits, American bankers were not particularly discriminating in extending credit to Third World countries. Thus, from June 1978 to June 1979, oil-importing LDC's debt to private banks increased from $109.6 billion to $140.3 billion.

Let us be clear about the uses of Fund credit in meeting the needs of debtor nations and the exigencies of international monetary stability. The IMF has not made significant amounts of credit available to LDC's to meet their debt crisis. Since 1976, the net use of Fund credit by the non-oil developing countries has declined by $725 million. Though the Fund has loaned to a few debtor nations with no other options, it has actually taken in more money than it has released.

How can this be? When capital-starved LDC needs have dramatically increased, why have IMF funds played a decreasing role in meeting these needs? There is only one answer. The conditions attached to the receipt of IMF credit are so onerous that most LDC's would rather borrow money commercially -- even at much higher rates -- than accept Fund credit.

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This fact is a shocking commentary on the economic prescriptions which accompany IMF lending activity, and suggests the inadvisability of an increased US quota. The cases of Jamaica, Turkey, and Peru illustrate why LDC's avoid negotiating with the IMF.

Jamaica's debt reached crisis proportions in 1977 when it appeared that default was imminent. Jamaica appealed to the IMF when private banks refused to refinance their loans. The IMF's extension of credit to the Manley government was conditioned on the adoption of a harsh regimen: Jamaican currency was devalued 30%, wages were reduced, credit was tightened, and government-sponsored social programs were strictly curtailed. The effect on the lives of the Jamaican people has been tremendous: unemployment soared to 25%, income fell by 35%, and the price of essential imports (including food, oil, and capital goods) shot up. Yet despite IMF claims that their strict monetarist prescriptions would get the economy moving again, the economic outlook hasn't improved. An October 9, 1979 report in the New York Times describes the situation:

> "... After more than a year of strict adherence to the conservative economic policies of the IMF, which has lent more per capita to Jamaica than any other country in the world, the Caribbean island is still mired in stagnation. Despite or because of the IMF's recommendations, in the past year real wages have fallen by more than a third here, consumption is down, malnutrition seems to be rising, and economic growth, for the 5th straight year is negative... If its economic troubles are creating problems for the Jamaican government, they are potentially highly embarassing for the IMF."

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Turkey provides another example of the kinds of economic prescriptions which accompany the receipt of IMF credit. A December 1979 NY Times report describes the deprivation resulting from IMF-imposed economic measures -- a 78% devaluation of the Turkish lira, steep increases in the price of steel, gasoline, sugar, fertilizer, and other products, and a sharp decline in average wages.

> "One million Turks earn a net salary of 5,000 lira, a little more than $100 a month and have to spend half that on rent. The balance is not enough to live on, according to economic reports. Sociologists note that in the poorer quarters around Istanbul and Ankara, children are yellow from undernourishment."

Here again, the poor pay the price for IMF credit, but the promised benefits of the credit on Turkey's economy remain to be seen.

Perhaps the most tragic of the IMF's "basket cases" is Peru. Bankers were eager to cash in on high copper prices and the possibility of oil discoveries in Peru. Some critics report that American banks actually "peddled" loans to the Velasco government in the 1970's. By 1976, when copper prices plummeted and the oil bonanza failed to materialize, Peru faced bankruptcy. The private banks refused to re-negotiate the loans. Enter the IMF: in exchange for a standby loan package, the Fund instituted its typical monetarist austerity formula, designed to dampen demand and curtail inflation. The currency was devalued, government food subsidies and social programs

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were eliminated and wages repressed. An important condition of the IMF credit was the promise that private bank loans would be repaid on schedule.

Again, the human consequences of the Fund's prescriptions have been appalling. Jose Carrizo, a Catholic priest who works with the poor in the barrios of Lima, Peru, described the effects of the IMF's stringent "stabilization" program in Peru:

> "In the last four years, the worker's real buying power has been cut in half. Only 45% of the 5.2 million in the work force have stable work. The price of bread has jumped 1000 percent. Per capita calorie and protein intake are but two-thirds of those listed by the Food and Agriculture Organization as the vital minimum. Condensed milk consumption in Lima plummeted from 560,000 kilos in December 1978 to 280,000 in March 1979. The relation between such statistics and the rising infant mortality rate is obvious."

The message is clear in Jamaica, Turkey, Peru, and other Third World countries: to obtain Fund credit, governments must relinquish their economic independence to Fund technicians who, in case after case, prescribe rigid measures to dampen internal demand in the hopes of combatting inflation and encouraging economic growth. It is no surprise that the IMF has had trouble loaning its money in the last few years!

Tanzania is a case in point. Though the country faces significant balance of payments deficits and is badly in need of credit, the government recently rejected an IMF loan of $300 million because of the conditionality attached. The IMF's "standard package" of proposals included cutting government spending and social services, ending price controls

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and devaluing the currency. In rejecting the IMF terms, President Julius Nyerere indicated that Tanzania would not relinquish her self-reliance because of economic problems.

The IMF justifies its conservative economic policies by claiming that they are required to prevent default and further economic decline. How successful are IMF policies in achieving the Fund's stated goals of combatting inflation and encouraging a better balance of payments position?

In 1978, the IMF prepared a special report to evaluate the effectiveness of stand-by programs carried out between 1973 and 1975. The Fund admitted that:

> "...less than one third of the programs included in this survey can be deemed as having been successful, in the sense that policies were broadly implemented, the balance of payments at the end of the program period was better than at the beginning, and that this improvement was sustainable with a continuation or some adaption in policies.

The report continues with a further indictment of stabilization programs as ineffective in controlling the rate of inflation:

> "The performance in relation to price targets was, in general, not successful. Of the 20 cases for which relevant price statistics exist, in only nine was there an actual reduction in the rate of inflation, but in most cases, the actual rate was higher than the one envisaged in the program. Only four programs achieved their aims in respect to price inflation."

The price of the IMF's myopia is not only measured in malnutrition, deprivation, and death in those Third World countries forced to rely on Fund credit. These conditions

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inevitably have political consequences. In considering increased participation in the IMF, this Congress must examine the destabilizing affect that IMF-imposed conditionality has on politics in the Third World.

Consider the case of Turkey. Former Prime Minister Bulent Ecevit agreed to the previously described IMF stabilization plan in 1979. He was swept out of office last July and political leaders stress that the IMF deal was a major factor in the downfall of his government. The new government is forced to implement the same harsh conditions. But the same domestic instability which toppled the Ecevit government is facing Prime Minister Suleyman Demirel: political violence, which has taken 2,400 lives in the past two years, is steadily increasing; an average of 10 persons are killed every day. Political stability in Turkey is absolutely essential since the invasion of Afghanistan and our loss of influence in Iran. Yet the starvation diet imposed on the Turkish population by the IMF is jeopardizing the political viability of a strategically essential American ally in the Middle East.

Mr. Chairman, let's not kid ourselves. It is clear that Third World economies do not benefit from an increased IMF role. It is clear that the world's poorest do not benefit from IMF loans. It is clear that political stability in the Third World is not enhanced by IMF activities. Who, then, are the beneficiaries of our tax-funded $5.6 billion bequest to the Fund? The answer is easy: the private banks, of which American banks are the largest.

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There were representatives of the big banks before this Congress lobbying for the creation of the supplemental facility in 1977 and there will be bankers before this Congress to lobby us on increasing our participation this year. The reason is obvious: with the IMF providing the funds to underpin the riskiest loans and providing the muscle to squeeze repayment from the world's poorest countries, the private banks can continue to reap enormous profits in the Third World. (According to the latest figures available from the Federal Deposit Insurance Corporation, American banks' profits from international lending activity in 1978 came to $1.2 billion -- a whopping 10% of total profits.) This relationship was so obvious that the Wall Street Journal dubbed the creation of the IMF's 1978 supplemental financing facility the "Bankers Relief Act".

It is clear that international economic stability is not enhanced by this convenient arrangement. While expansion of the IMF will increase the security of current international bank loans, increasing the power of the IMF -- as it now operates -- may well lead to a shakier system with more difficult problems in the near future. In reducing the risk on current bank loans, expansion of the IMF encourages more bank loans, and more destabilizing exposure. It also leads to uncertain and dangerous foreign policy and economic ramifications.

If the winners in this arrangement are international bankers, the losers are surely the world's poor who have paid with their

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lives for the Fund's short-sighted and incompetent economic programs. And the other losers are the American people, whose tax dollars are being spent to further perpetuate an inherently unstable economic proposition.

It is time to put a stop to this business. The United States Congress does not belong in the business of forwarding $5.6 billion to underpin private bank gambles in the Third World. The Congress has no business increasing the power of the Fund in assuming economic sovereignty in the Third World. The Congress has no business encouraging Fund activities which starve the world's poorest. The Congress has no business undermining political stability around the world through IMF intervention.

The legislation we consider today is unacceptable. Unless this "Bankers Relief Act of 1980" includes the following provisions, I will be obliged to encourage my colleagues in the House to defeat HR5970.

1) The IMF should be encouraged to develop stabilization programs which are directed towards production and development.

2) The IMF staff should be forced to take into consideration the potentially pernicious influence of strict conditionality as it has been applied in recent upper credit standby agreements on the quality of life in the Third World.

3) The Congress should have a chance to evaluate the considerations which went into the development of the IMF's stabilization programs.

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4) Basic human needs should be included as part of the Fund's performance criteria for standby stabilization plans.

5) The United States director to the Fund should vote against the use of Fund credit for programs which have a damaging impact on the quality of life of the people who live in countries which receive Fund credit.

6) The United States director to the Fund should report yearly to the Congress on the overall impact of IMF transactions on basic human needs.

7) The Department of Treasury should report to the Congress those domestic banks having loans outstanding from recipients of Fund credit.

Chairman NEAL. We would like to hear from the witnesses in alphabetical order.

Rev. Tom Burns, we will start with you.

STATEMENT OF THE REVEREND TOM BURNS, JUSTICE AND PEACE COORDINATOR FOR MARYKNOLL MISSIONARIES IN PERU

Reverend BURNS. Thank you, Mr. Chairman.

I would like to start the testimony perhaps in an unusual way. I hope to limit my remarks to the 15 minutes allotted.

I will start off with an old Hindu saying, which is: "Ask a hungry man how much is 2 plus 2 and he will say, four . . . loaves of bread."

It is my contention, and my sad story, to look at Peru after 3 years of the implementation of the International Monetary Fund-Peruvian Government policy of stabilization and find that hungry men have two loaves where they had four.

I would like to quote also from a letter of 1,000 colleagues of mine addressed to the Peruvian nation on November 3, 1979.

In that letter, they speak of the cries that they hear in the homes and in the marketplaces. I will just quote a couple of lines from that.

"Our people are hungry." Are hungry is underlined. "And today's hunger is the messenger of death. Hunger destroys and dashes hope. Hunger kills."

I think that sums up the feeling of my colleagues in Peru. I will detail this more concretely in the first part of my testimony and then I will go into more theoretical considerations at the end.

The IMF-Peruvian Government's policy of stabilization has meant that there would be no or substantially no food subsidies.

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And it has also meant a spiraling of the Consumer Price Index over the last few years.

I cite as a result of that policy, the hunger of the people: Dr. Hilary Creed, a British nutritionist, recently updated a study she did in 1972 to 1974 in my parish, the controlled study of fairly middle level of poor people.

She has found that, whereas 87.5 percent of the families drank milk in 1972-73, at this point none of them consume milk.

She also found substantial cutbacks in the consumption of any kind of meat or the elimination of that product, as well as substantial cutbacks in high calorie foods such as rice, noodles, oil, sweet potatoes.

Whereas, in 1973, the family paid out 78 percent of its income for food, today in 1979, food consumes 85 percent of that family's income.

If we take into account the loss in buying power of the people, this means that a family pays out 7 percent more of its budget to consume 50 percent less.

I would like to present to you today what a worker earning four times more than he did in 1974 or 1973 can hope to buy in a typical menu.

There is 1 pound of potatoes there. The milk that he can buy is half a gallon. He could buy one-half a loaf of bread. He could buy as well a pound of rice, a half pound of chicken, and nothing else.

That is for a family of six people for 1 day. And that is typical of my parish.

Calorie consumption at this point is 67 percent of the vital minimum. Protein consumption is between 45 and 50 percent of the vital minimum.

The conclusions are obvious.

The people in my parish at the beginning of 1979 began eating chicken feed. It is 50 soles a kilo. As of August of this year, we began getting reports of people in the rural areas eating chicken feed. Ten million chickens were consumed in Lima per month a few years ago. It is 1 million now.

Within the last year, chicken feed production has not dropped. This, of course, affects the infant mortality rate. Statistics on infant mortality are not reliable. But all the statistical evidence which has been presented that I have been able to check out shows a tremendous increase in rate if infant mortality.

The most conservative estimate that was made in the early part of this year was an increase of about 30 percent.

Taking into account my own personal experiences and reports of my friends and associates in Peru in terms of pastoral experience among the people, my personal estimate is that the infant mortality rate has risen in the neighborhood of 80 to 100 percent.

That means, more or less, 30,000 children have died that would not have died a few years ago.

Health—there is an epidemic of tuberculosis. I won't go into much more on that. That is obviously the result of malnutrition.

The IMF-Peruvian Government approved policies cut social programs. Plus malnutrition. You can't eat; you can't get medicine; you start getting other diseases; health suffers.

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There are rumors of typhoid epidemic in Lima at this time. You couldn't find—in 1977—X-ray plates. In 1978, you could not buy medicine for TB because it was in warehouses. The pharmaceutical company in my area did not send it out to the pharmacies because the people couldn't pay for it.

The crux of the matter, though, is in the question of the relationship between the work and real buying power. The IMF-Peruvian Government approved policies have reduced the labor force, fully employed, from around 50 percent in 1974-75 to about 38 percent of the work force at this point.

The real buying power in the same time has dropped to 60 percent of what it was in 1974-75.

What this means practically is, whereas one fully employed worker in 1974 supported six people with his income, in 1979 he was supporting eight people with 40 percent less income.

If a fully employed worker in September of 1979 went to buy two large loaves of bread—and we come back to the loaves of bread once again—if he were to buy two large loaves of bread a day, paid bus fare back and forth and was earning the minimum wage, at the end of the month, he would not be able to pay his water bill. I want to make that clear, according to the prices that were available in Lima at that time.

The conclusion is clear: When people don't work, they don't eat. And when they don't eat, they begin to die.

On page 12 of the prepared statement I have submitted, I would like to summarize this part of my testimony by reading my own quote: "A culture is being destroyed. A gentle and peaceful people has become enraged and violent; a hopeful people is on the verge of despair." Peruvian people, contrary to many sterotypes of Latin people, the Peruvian people are a working people. That is their No. 2 value. Their No. 1 value is their family.

"A working people is being forced to beg and a culture of struggle has become a culture of survival."

This has led in turn to increase of control and repression. I will pass over this quickly. Human rights in Peru are a result of the IMF-Peruvian Government solution, and I don't speak for other places. These policies to be implemented must be enforced, and to enforce them, there must be repression. There has been an alarming increase in repression in Peru over the last 2 years. There is no free press. There are no legal strikes, although there are a tremendous amount of illegal strikes with the resulting buckshot and bullets and teargas.

There has been arbitrary arrest and detention since July of 1976, when the international banks came to an agreement for a minis-tablization program with Peru.

Now, to the more theoretical or less concrete things.

Why is Peru in debt? Peru is a very rich nation in terms of mineral resources, with problems in the agricultural sector. But it has got a diversity of resources. It was the No. 1 fishing nation in the world in the early 1970's. It has copper. It has sugar. It has gold, silver, and now petroleum.

What happened?

Well, the military government came in 1968, took power and tried to bring about reforms. They overborrowed, mismanaged.

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Some of the reforms—I am sorry time makes me compress this area of my testimony because there were a lot more complicated factors involved in this.

That—heavy borrowing—was one dynamic. It was considered a good risk at the time, according to the International Monetary Fund, the World Bank international experts. Peru borrowed heavily because it was going to see new copper and petroleum exporting. That toward late 1973.

Petrodollars also influenced this. In 1973 and early 1974, the international banks, without the solicitation of the Peruvian Government, according to the Wall Street Journal, went to Peru to sell loans to Peru. The resulting loans were in the neighborhood of $3 billion, including all lending institutions, not just the banks.

Right after the loans were taken out, in 1975, in that area, we found out the oil bonanza did not exist. The fish had disappeared. The market prices in copper and sugar and other commodities had dropped and Peru was standing out there with a $5 billion public debt, $3 billion private debt, with no collateral.

So the banks came in in June of 1976 and agreed with Peru on a bank stabilization program. This was because of the new government. There had been a coup in 1975. The new government was not stable, and there was a good chance that the government would fall if they went to the International Monetary Fund.

From page 20 of my prepared statement, I will just read the summary of the reasons why Peru is in debt and I will try to take 3 or 4 more minutes to finish my testimony.

To sum up, many factors contributed to Peru's indebtedness. Overly optimistic assessment of all involved, heavy borrowing on the part of the military, including arms, aggressive salesmanship on the part of the banks, as well as their interference in the Peruvian economy, the world market, overfishing, mismanagement, and weak government.

All these factors are responsible for the debt with the Government playing a major role and the international banks a less major one. Although the specter of the International Monetary Fund policies served to dissuade the Government from seeking it out and to assure the banks of a fallback position, it did not play any significant active role in the indebtedness of Peru.

Nor did the people. They neither sought out the loans nor were they consulted.

Finally, I wish to get into the question of the role of the International Monetary Fund. For whom has the International Monetary Fund-Peruvan Government agreement meant stabilization? It has stabilized the situation of the international banks, who are afraid of an economic dominos problem. It has stabilized the situation of the exporters in the nation. It has stabilized the situation of large internal companies which can weather the storm with a reduction of consumership in the local market.

And I would like to make a special mention here of the CERTEX. There are companies of nontraditional exporters—as part of the new laws in Peru to encourage exports, there is a tax writeoff, a tax exemption of about 30 percent. This includes milk. It includes noodles, excess production. People can't eat, they can't drink milk, but it is being exported.

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Concrete figures: In the middle of this year, you could export noodles from Peru for 56 soles a kilo, with a tax writeoff. You could buy noodles for 56 soles a kilo outside the country. That is what it cost. In Lima, it costs 90 soles a kilo.

Now, this has also implications—first of all, it has political implications. To say that the International Monetary Fund is not a political institution is to use politics in the very narrow sense and rigid sense. It is a laudable goal to say that there should not be partisan politics in the International Monetary Fund. That should be worked on.

But politics really means, in its root form, it comes from the Greek word "polis," which means the life of the people, the order of the life of the people. And if you touch bread on the table, that is political. It causes reactions.

The International Monetary Fund policies are identified with American forign policy. I am talking about what the attitude of the people in the Third World is and in Peru. It is clear to them that there is no doubt that the International Monetary Fund is an indirect instrument of American foreign policy. It favors banks. Whether or not they are right is not important. It is a political attitude and a reality which exists.

Mr. Blumenthal in this context writes a letter to the Finance Minister of Peru on August 2, 1979, and I wish you would hear it from the context of the poor in Peru, not from our own context. I am sure it is taken out of our context. But try to understand what it means to those people and how it substantiates an attitude. I will just read two lines from it:

"It has been personally gratifying to collaborate in Peru's comprehensive efforts to stabilize its economy."

What does stabilization mean for the poor?

"Peru has indeed made notable economic strides under your strong leadership. Together we have established a sound basis for closer bilateral understanding on key economic and financial issues."

That is political, and in a political context.

Finally, the insensitivity of the IMF. The IMF is totally insensitive, and it comes out of what I think is a naive perception of the world. It is funny that I, a religious man, often accused of being idealistic and naive, say this. It is paradoxical that today a religious man standing before you who long ago stopped believing that religion was separated from life, stands before you to talk about an IMF that thinks that somehow economics is separated from life.

There is a belief that the responsibility for the consequences for this cannot be accepted. There is an aura of sacredness about the International Monetary Fund which, despite the cries of people, despite the agony it causes to the poor, cannot be touched, because of a belief that its policies work.

There is also an attitude that the International Monetary Fund economic policies are amoral. When it touches bread and life, what more moral questions can you touch upon, when you take bread off the table, structurally or otherwise, when children die, structurally or otherwise? That is moral.

We must change. We can no longer sit by and wait. We need to take into account the human needs of the people. We need also to

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make sure that the banks are responsible in their lending, as well as the Government of Peru. We can no longer have a situation in which two plus two economically means two loaves for the poor.

I thank you, Mr. Chairman.

[Reverend Burns' prepared statement with attached supplemental material follow:]

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64

TWO LOAVES OF BREAD

The Impact of the IMF-Peruvian Government Economic Stabilization Program on the Peruvian People

Statement Prepared for Testimony
Before the U.S. House of Representatives
Committee on Banking

Subcommittee on International
Trade, Investment and Monetary Policy
Congressman Steven Neal, Chairman

February 6, 1980

By
Rev. Thomas Burns, M.M.
Catholic Missionary in Peru

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REV. THOMAS BURNS M.M.

Graduated 1964 from Maryknoll College in Glen Ellyn, Illinois with a B.A. in Philosophy.

Received Bachelor of Divinity in Theology from Maryknoll Seminary, Ossining, N.Y. in 1967.

Pursued extensive studies in Master of Community Development Program at the University of Missouri, Columbia, Mo. in the summers. '66-68.

Received Master of Arts in Theology from Maryknoll Seminary, Ossining, N.Y. in 1969.

Ordained to Priesthood, May 14, 1969.

Lived and worked in Peru from March 1970 to May 1979.
Four years (1970-1973) with Aymara People in Puno, Peru.
Over five years (1974-1979) in a poor Catholic parish of some 100,000 people on the outskirts of Lima, Peru.
Primary work: Development of Basic Christian Communities.
Justice and Peace Co-Coordinator of Maryknoll in Peru since 1977.

Currently on Sabbatical.

Dedication

to

Marcelino Castro Gamboa
Feb. 4, 1979

and

Alberto Chaman Lescano
Jan. 5, 1980

"Que sus hijos no sufran como Uds. han sufrido"

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INTRODUCTION

The purpose of this rather extensive testimony is to clearly demonstrate that the stabilization program agreed upon by the Peruvian government and the International Monetary Fund to assure payment of Peru's debt to international creditors (especially private banks) is being shouldered by those who cannot afford it, Peru's poor. Stabilization equals desperation and starvation to these people.

This testimony is extensive. Frankly the reason for this is that so very little is known about the Peruvian people in our intellectual circles. In the first part of this testimony I deal with what this stabilization program has meant concretely in terms of life, health and hunger to the poor. Graphic illustrations and "people" data are the best way to get the message.

In the second part, I deal with more theoretical questions such as how Peru got into debt, my criticism of the stabilization programs, the politics, and the unrealistic assumptions of the Fund.

Part I "Stabilization" as Experienced by the People

> Ask a hungry man "How much is two plus two?"
> He will answer "Four . . . . . loaves of bread."

I have dedicated this testimony to Marcelino Castro Gamboa and Alberto Chaman Lescano. They were neighbors. Both died before they reached 45 years of age. Marcelino was shot to death by police defending his job at Cromotex, a textile factory. Alberto died because of sheer dedication to his neighbors and family. They were my parishioners.

They exemplified the most important value of the Peruvian poor: "Que

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mis hijos no sufran como yo he sufido." (That my children not suffer as I have suffered). To this end men and women like Alberto and Marcelino migrate to Lima from the provinces and live in one room back-alley hovels in the center of the city or invade the desert hills that surround it and set up shantytowns. Two million people live in such shantytowns around Lima.

Generally, it takes one generation (20 years) to get running water, light, sewage, a school and a four room unfinished brick home with the barest of furnishings. My parish of 100,000 would be a typical example: ninety percent now have lights; 30 percent have access to running water and sewage; 35 percent have "finished" homes; there is no garbage collection in 70 percent of the parish; 99 percent of the streets are unpaved, etc. etc.

A SITUATION OF HOPE...

At the same time, however, when I arrived in Lima in Januray of 1974 after four years of service to the Aymara peasants in Southern Peru, despite the apparent misery of the people, I found these shantytowns to be centers of hope. There was a spirit of sacrifice with slow progress being made. The people worked together and could see concrete achievements. The problems were tremendous, but not insurmountable. In sum, I found a hard working, community oriented and gentle people who were moving ahead.

...GONE SOUR

Things are different today. I quote from a recent letter signed by more than 1,000 of my co-religious and released on November 3, 1979, the feast of St. Martin de Porres - Peru's Patron of Social Justice. Its title is "Give us this day our daily bread:"

"As Priests, Brothers and Sisters, we wish to put into words the complaints

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we hear all day long in the homes of our people, the cries we listen to every day in the streets and the markets. Many cries of protest have been shouted out these past few years. Is it possible that our people have basis for their complaints? Do they cry out in bad faith or with subversive intentions? No! The exchange mentioned above expresses the feelings of countless individuals who have been deprived of their fundamental rights and cruelly sentenced to a slow death. And so, with deep faith in the Lord and wishing (in the words of John Paul II to the Bishops at Puebla) to be ... the voice of him who cannot speak or has been silenced, we make an appeal to all. We proclaim before the Lord of Life:

"Our people are hungry, and today's hunger is the messenger of death. Hunger destroys the person and dashes hopes; hunger kills."

The letter goes on to detail what my colleagues have witnessed. In this part of my testimony, I will proceed by quoting from this letter and then elaborating on the lines cited. I hope this will give us a better understanding of the utter deperation of the people.

A. HUNGER

"... thousands of children condemned to death or irreparable physical and mental damage for want of food."

The IMF-Peruvian Government Stabilization Program has resulted in food subsidies being essentially eliminated and a spiraling consumer price index. From the beginning of the mini-stabilization program of the banks in June of 1976 (cf. Part II) and the entrance of the IMF in early 1977 to the end of 1979, the Lima Consumer Price Index (1973=100) has risen from less than 200 to almost 900.

In December 1978, 560,000 kilos of milk were consumed in Metropolitan Lima whereas three months later in March 1979 that consumption was reduced

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to 280,000 kilos. A British nutritionist, Hilary Creed did a controlled study in the shantytowns of Pamplona Alta and Ciudad de Dios in 1972-1973 under the sponsorship of Johns Hopkins University and did a follow up study with the same people this past year. She found that 87.5% of those who drank milk in 1972 no longer did so. Among her other findings are that all of the families had significantly reduced or totally eliminated meat from their diets. Such calorie-rich foods as rice, noodles, oil and sweet potatoes (staples of the Peruvian poor) had also been sharply cut back.

Another important finding of Ms. Creed was that whereas in 1972-1973 these families spent 78% of their income on food, they now spend an average of 85%. This does not seem to be a significant increase until we compare monthly menus.

What could a worker who earned 5,151 Soles in 1973 and now earns 20,209 Soles buy for his family in one month?

Item	Amount in 1973	Amount in 1979
Mini Bread Rolls	448 (2 per person per day)	225
Noodles	15 lbs.	9 lbs.
Rice	55 lbs.	30 lbs.
Potatoes	65 lbs.	37 lbs.
Condensed Milk	31 cans	17 cans
Beans	9 lbs.	2.2 lbs.
Sugar	28 lbs.	15 lbs.
Beef	9 lbs.	2.2 lbs.
Chicken	10.5 lbs.	7 lbs.
Cooking Oil	3.6 Lt.	1.5 Lt.
Bus fare	120 bus fares	60 bus fares
Kerosene	13.7 gallons	7 gallons
Barrels of Water	18.4 barrels	9 barrels

Source: Jornal, a labor magazine, published monthly. July 1979, p. 17.

This means that this family spends 7% more of its real income to eat 50% less.

A reduction in food consumption, of course, leads to a loss of calories and protein intake. From 1971 to 1974 the Peruvian population in general

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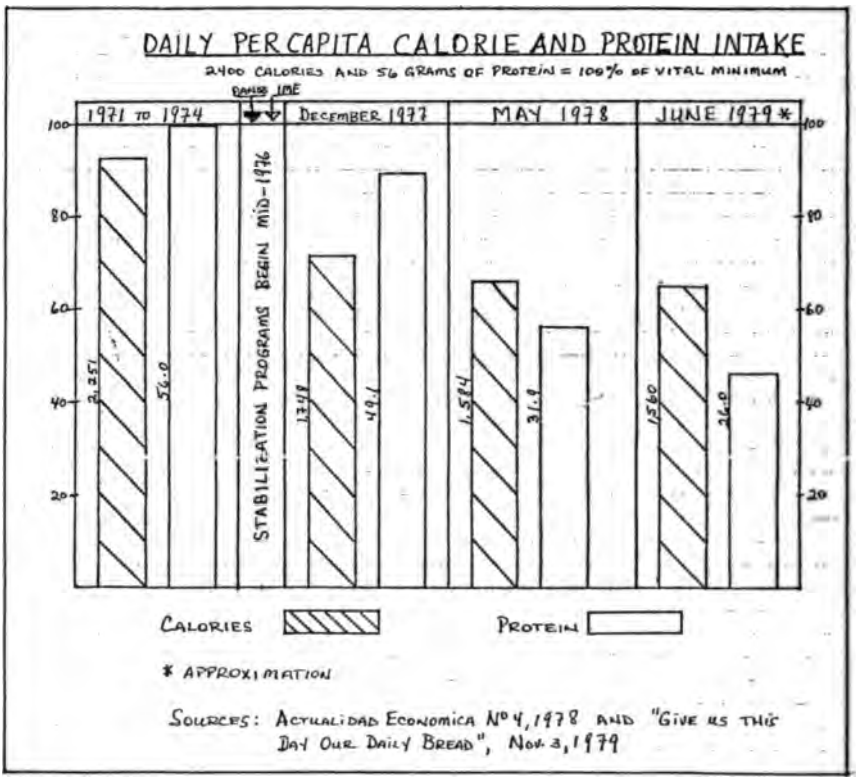
consumed close to the vital minimum (FAO standards) while at present the daily per capita intake of calories and proteins is in the area of 65% and 46% of FAO standards.

GRAPH #1



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In early 1979 we began to hear reports of people in the city eating "Nicovita," a chicken feed which contains toxic substances of questionable benefit to human beings. But it costs 50 soles (20 cents) a kilo, and while it isn't tasty, it does fill empty stomachs. By the end of August, even peasants had begun to make use of this dish. Planting season was soon to begin and the stores from the harvest were minimal.

This has lead to the blatant contradiction that while chicken consumption in Metropolitan Lima has dropped from over 10,000,000 chickens per month a few years ago to a little over 1,000,000 per month currently, chicken feed consumption has shown increases in the past year.

Infant mortality has also registered a notable increase in the past two years. An exact figure is very hard to come by. There are several reasons for this. Statistical methodology differs, and it is hard to keep up to date in a crisis situation. Furthermore, the reality is that many more infant deaths are simply not reported these days - their parents cannot afford the paperwork. Taking into account the statistical information available and my own grass roots experience as well as more recent reports from my colleagues in Peru, my most reasonable estimate is that the infant mortality rate has risen between 80 and 100%. Concretely, this means that somewhere between 30,000 and 40,000 more infants died in 1979 than in 1975. No matter how you cut it, tens of thousands of infants (0-1 year) have died this past year who would not have in other circumstances.

B. HEALTH

"Families are plagued with every type of illness, and they have reached epidemic proportions (e.g. tuberculosis) with no medicines available to combat them."

The IMF-Peruvian Government Stabilization Program has meant cut backs in

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social spending.

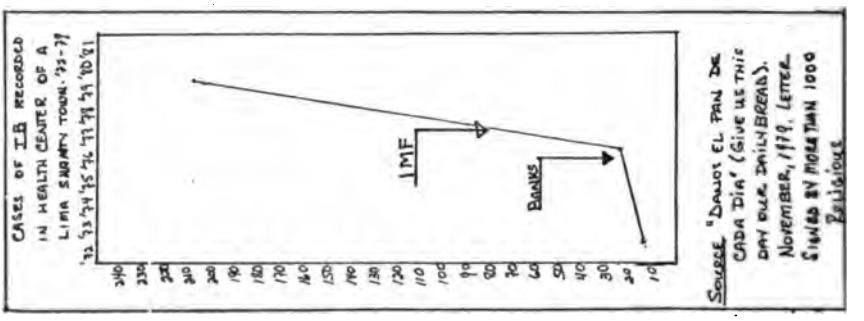
If you don't have a balanced diet, your health suffers. This has been reflected especially in the increase in influenza, measles, tuberculosis and typhoid. Perhaps the most dramatic increase has been registered in the area of tuberculosis.

Exact statistics are available only until 1976:

1970	23,843
1971	18,942
1974	16,549
1975	16,688
1976	22,257

As can be readily seen, in 1976 an increase of over 33% was registered. Speaking as one who has grass roots experience, I can testify that this increase was not noticeable to me at all. It was rather in 1978 and 1979 that I personally noticed a significant increase. It was so startling that a parish close to mine took upon itself the task of investigating this increase on a home to home basis. The results were eye opening: one in every three homes had at least one case of T.B. This same increase is reflected in the records of a small clinic in another Lima shantytown.

GRAPH #2



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These initial findings are, of course, startling but not unexpected if we take into account the nutritional level of the people, the cut in social spending and the economic condition of the poor these past few years. At one point in 1977 no X-ray plates were available in the country. In 1978 it was reported that a local drug company had a storeroom full of medicine for T.B. while none was available for sale in the local pharmacies. The reason was simple: although T.B. was reaching epidemic proportions, nobody was buying it because the price was prohibitive. So it sat on the shelves.

Because of the economic crisis, subsidized medicines are now non-existent. A patient in a Lima hospital must send out to the pharmacy for such things as gauze or adhesive tape. None is available in the hospital.

In early 1979 it was reported that the Department of Agriculture of the United States returned a shipment of 36 thousand cans of fish to Peru because they were contaminated with typhoid producing bacilli (Salmonella). At the end of 1979, a serious increase in the incidence of typhoid in Lima was causing grave concern.

C. INCOME - WORK

"... mothers and fathers struggle in desperation to earn a pauper's purse, while living in subhuman conditions; ... unemployed, underemployed, street vendors and odd-jobbers easily make up more than half the work force, and are victims of a (national) policy which does not create new jobs and legitimizes job insecurity; with each passing day even those with jobs earn less than necessary to live."

The IMF-Peruvian Government Stabilization Program has meant a devastating loss of jobs and real buying power. Article One of the IMF Charter makes a

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priority commitment to an increase in employment as a result of its policies. Yet in my study of IMF data tables I have yet to find any statistics relating to employment.

This is the crux of the matter. Before proceeding, I wish to confront a bias held by many people. It is the belief that Latin Americans are lazy. I want to state categorically as the son of working parents, that the Peruvian people (especially the poor) are a working people. After their children, work is their most important value.

The following graph (#3) will serve to corraborate the above statement of my colleagues. Taking into account the fact that hidden unemployment statistics are not available for 1974 or 1975, it would be safe to estimate real full time employment for those years in the area of 50%. By the end of 1978 the figure had dropped to 40% with the projection for 1979 being closer to 38% (cf. Graph 3, p. 10).

In order to fully understand the importance of these statistics, we must relate them to the loss in buying power of the Peruvian worker. Taking into account the same years (1974 and 1978) it is clear that the real buying power of the average fully employed worker in 1978 was 50% of what it was in 1974 (cf. Graph 4, p. 11).

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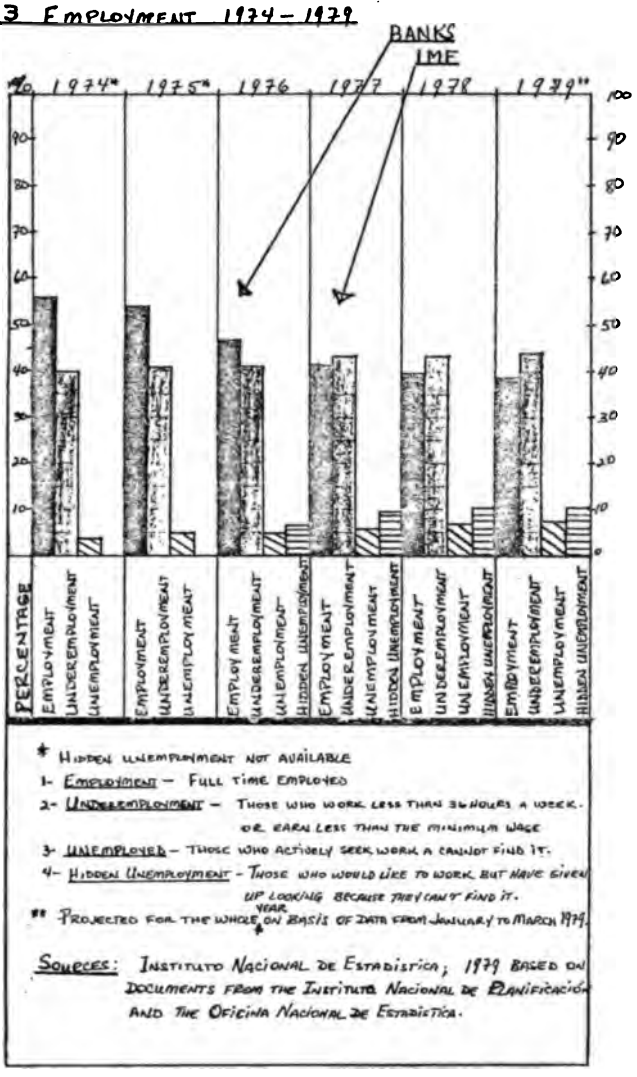
GRAPH #3 EMPLOYMENT 1974 – 1979



* HIDDEN UNEMPLOYMENT NOT AVAILABLE

1- EMPLOYMENT – FULL TIME EMPLOYED

2- UNDEREMPLOYMENT – THOSE WHO WORK LESS THAN 36 HOURS A WEEK. OR EARN LESS THAN THE MINIMUM WAGE

3- UNEMPLOYED – THOSE WHO ACTIVELY SEEK WORK & CANNOT FIND IT.

4- HIDDEN UNEMPLOYMENT – THOSE WHO WOULD LIKE TO WORK, BUT HAVE GIVEN UP LOOKING BECAUSE THEY CAN'T FIND IT.

** PROJECTED FOR THE WHOLE YEAR ON BASIS OF DATA FROM JANUARY TO MARCH 1979.

SOURCES: INSTITUTO NACIONAL DE ESTADISTICA; 1979 BASED ON DOCUMENTS FROM THE INSTITUTO NACIONAL DE PLANIFICACION AND THE OFICINA NACIONAL DE ESTADISTICA.

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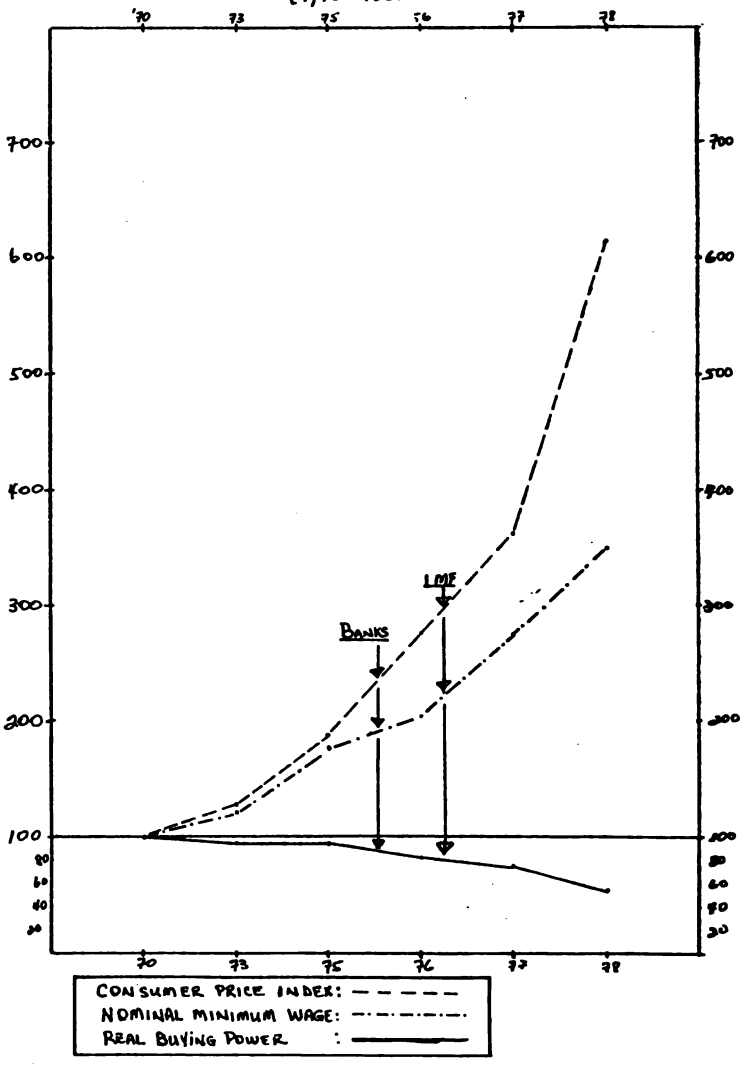
GRAPH #4

REAL BUYING POWER - 1970 — 1978 (END OF EACH YEAR)
(1970 = 100)



SOURCE: BASED ON DATA FROM INSTITUTO NACIONAL DE ESTADÍSTICA

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Putting it in other words, while one worker was the major breadwinner for six people in 1974, at the end of 1978 this same worker had the major responsiblity for feeding 8 people with 40% less income.

Most families, of course, will have another person who is underemployed. But this person's contribution to the family basket is minimal. In September of 1979 for instance if a person earning the minimum wage were to buy two large loaves of bread a day and had to pay for transportation to and from work, he or she would not have enough money left over at the end of the month to pay the water bill. Most underemployed, by definition, earn less than the minimum wage.

This tragic situation effects other dimensions of the life of the poor. I will mention just a few of the traditional pastoral problems which have grown in frightening ways. An increase in delinquency and violence; prostitution is now commonplace; men dehumanized by unemployment become drunks or wife beaters or abandon their homes in despair; children beg in the streets while others work all day just for food; widespread mental illness is now taken for granted.

I realize that some will characterize what I have said so far as melodrama. Let me state unequivocally that it is dramatic ... and it is true. I have seen it with my own eyes.

A culture is being destroyed. A gentle and peaceful people has become enraged and violent; a hopeful people is on the verge of despair; a working people sees itself forced to beg; a culture of struggle has become a culture of survival.

Once again I will quote the words of my colleagues: "God reveals himself ... as a God who gives life, conserves it, defends it, rescues it from oppression and makes it full and definitive. ... We believe in the Lord and

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therefore we believe in life; and because we know that there are sufficient resources for all, we cannot accept this solution to the present crisis, a solution of hunger, death and the extermination of the people."

Control and Repression

The loss of work and real income lead to malnutrition and disease which in turn leads to a dashing of hope, violence and death by starvation. In order to implement such an international policy, the government must rule by persuasion, control and repression. I wish to stress here, however, that the fundamental cause of these violations of civil-political rights in Peru has been the economic program: to keep real wages down it must repress and it has. I will cite but a few examples.

On July 19, 1977, a national one day strike was declared in response to the program. It was the first such strike in fifty years and was a resounding success. This caused the government to decree the following day that employers could dismiss at will anyone "responsible" for the strike. Between five and six thousand workers were fired and subsequently blacklisted. About half of these workers held union posts. It was a move clearly aimed at the destruction of the union movement. From the point of view of Western jurisprudence, it was clearly illegal since the law was retroactive. As such it was condemned by the legal profession as well as the Church.

This tactic of the government, while having some impact, essentially failed. Since the initial strike there have been four additional national work stoppages over the past two years.

Besides the national strikes there have been countless local strikes. All of these strikes have been declared illegal. De facto in Peru there is no legal right to strike.

So the various unions have been forced to strike illegally and have been

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met with tear gas, buckshot, and bullets. Of special note have been the teachers' strikes. In 1978, SUTEP, the teachers' union was out on strike for 85 days. This past year, they went our again for 118 days. Caretas, a moderate Peruvian magazine has stated that Peruvian professional teachers are the lowest paid in the world.

The government used every means available to break these strikes. The teachers were accused of being traitors, agitators, subversives. Daily all the means of communication (other than weekly magazines) on the national level controlled completely by the government, vilified the teachers or told the people that the strike had failed. It refused to dialogue with the teachers or even recognize the legality of their union despite the fact that it had many times more members than the government-controlled union. During the course of the 1979 strike, at least 27 people were killed, 109 were wounded and/or tortured, thousands detained and over 5000 teachers were dismissed from their work.

Abel Callergos Graneros a member of the Executive Committee of the union, "fell" to his death from the fifth floor of the teachers' cooperative building on February 26, 1979. The only people present with him in the room were two members of the P.I.P. (Peru's Investigative Police).

Another example was the Cromotex case whose first anniversary was celebrated Monday. Six workers (including Marcelino) and a policeman died. The rest were imprisoned and fired, as well as beaten. Four were held for military trial until December 21, when charges were dropped. It has been reported to the UN Commission on Human Rights. Still another case on file at the UN was the dismissal and brutal repression of over 100 miners from the Southern Peru Copper Corporation. Dozens of peasants have been killed and hundreds jailed over land. The most recent case is that of Ondores in the Department of Pasco. In that case on December 18, 1979 police

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assault troops killed two peasants, wounded 15 and jailed 44. Twenty-two were still in jail on January 25, 1980. They were run off land legally theirs from colonial times.

Many more cases could be cited. Suffice it to say that freedom of the press does not exist, nor does the freedom to strike or demonstrate. And arbitrary arrest and detention without charges have been the order of the day since July 1976.

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PART 2 WHY?

How did this all come about in Peru? After all Peru is certainly not one of the poorest LDC's and unlike many developing nations it is not a one-commodity economy. In theory, at least, it should not be in such a disasterous situation.

Peru is a country of some 17 million people, 3% rich, 7% middle class and 90% poor. Per capita income is estimated at between $500 and $700 per year. The population is 55% urban and 45% rural. Economically, Peru faces problems in the agricultural sector because of its terrain, (Andes Mountains, coastal desert and vast jungle area), but in other areas of the economy it is richly diversified. Its mineral resources are vast and varied: copper, tin, silver, ~~gold~~ GOLD and most recently petroleum; and it is one of the leading fishing nations in the world. So why the disaster?

I. BACKGROUND - THE DYNAMICS OF PERU'S DEBT

On October 3rd, 1968 the Peruvian Military staged a coup and announced the beginnings of radical reforms in the economic as well as socio-political structure of Peru. Among its aims were the stabilization of the Peruvian economy, the creation of a strong national industrial sector in the coastal cities and the participation of the poor in the economic growth to take place.

To this end a whole series of reforms were initiated, the most significant of which were the nationalization and state control of the major national resources (fishing, petroleum, and mining to the point where, by the mid-seventies, the State controlled over 50% of these resources), the agrarian reform, the industrial community and the

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education reform. Fundamentally, these reforms were geared to the creation of a modern industrial base on the coast and an integration of workers and peasants into the economic life of the nation.

By early 1973, the economy had been stabilized and Peru had shown an encouraging rate of economic growth over the previous three or four years. However, if the ambitious long-range projects of the military were to be realized, restrictions on imports had to be lifted and some significant borrowing had to be done to finance the projects as well as the arms buying to protect a more tenuous geo-political situation and to win the support of reluctant members of the military (not to mention corruption). This was the rational of the military at the time.

It seemed to be a good risk. With a healthy and diversified economy as well as bright prospects in the future -- large new mining operations were soon to begin and scientists were speaking of a tremendous oil bonanza -- it looked like a good investment.

On the other hand, in retrospect some important factors were probably not given sufficient scrutiny. There had been a slack in the fishing industry which most observers thought to be cyclical. Peru, it was thought, would soon regain its No. 1 status. This was coupled with the unusually high price of copper on the world market over the previous couple of years. At the time, however, the judgment of the government (supported by the IMF, the World Bank and other international experts) was that there might be a couple of slow years but by the end of 1976, better times would be coming.

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A. PETRODOLLARS

Concurrent with this dynamic on the national scene was another dynamic in the international arena which would eventually have far-reaching effects in Peru. It was the oil crisis of 1973.

At this point in its history Peru was producing about 2/3 of its own oil needs. So while the rise in oil prices certainly had its effects, it did not play the major role it did in the non-oil producing nations.

On the contrary, Peru's oil potential spurred aggressive loan-selling by international banks to Peru. As a result of the increased oil prices, the Eurobanks (especially) found themselves with billions of extra dollars and little increase in demand in the industrial nations. So they turned to the better investment opportunities in the Third World. Peru was a prime candidate. "Recalling the scene in Lima at that time, a local banker says; 'Foreign Bankers wanted to give us money before we asked for it. The Italians had lira for a dam. The French had francs for our steel mill!' Peru looked like a no-lose situation because its Amazon Jungle Region was supposed to be practically one vast pool of oil just waiting to be tapped." (Wall Street Journal, Sept. 1, 1977)

So the Peruvian Government presented the "project hungry lenders" with requests and eventually received $3 billion. Most of the new debt came from American and European banks although the trans-Andean oil pipeline added substantial amounts to the total: That borrowing was from Japan.

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B. DISASTER

By 1975 it was becoming apparent that Peru was in serious financial straits. Due to the 1974 recession, world prices for such Peruvian exports as copper and sugar had plummeted; this was complicated by the fact that by now it had become apparent that the "cyclical lull" in the fishing industry was no such thing. Rather than being caused by climatic conditions, its root cause was overfishing and though still a major fishing power, Peru was no longer number one.

As 1975 progressed it also became apparent that the oil "bonanza" was highly overestimated. Peru would probably produce enough oil to meet national needs but little beyond that. These factors as well as others combined and resulted in a coup within the military government. It would take almost a year before the post-coup power struggle within the military was clearly decided though its eventual direction could be seen by early 1976.

By early 1976, it was also apparent that the Peruvian economic situation was precarious. In March of the same year, Peru's government had to go to the banks once again, this time to handle a growing balance of payments dilemma. An agreement was reached with the banks in June of that year.

Normally, at this stage of the game, it would have been high time to turn to the International Monetary Fund but due to the fact of the lack of consolidation within the new regime, as well as its lack of popular support, both the banks and the military agreed that the IMF's stabilization program could very well bring down the government.

So the banks decided that their best bet was to extend loans to Peru in two payments of $200 million each. But with conditions:

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1. An orthodox stabilization program, though of a milder sort than the IMF would have imposed, involving a 44% devaluation, price increases and minor budget cuts;

2. Better treatment for foreign investment, including opening the jungle and coastline to private oil companies, favorable agreements with Marcona on a price to be paid for its mine and with the Southern Peru Copper Corporation on payments due;

3) Partial withdrawal of the state in favor of local enterprise, beginning with the sale of Pescaperu's anchovy fleet to private interests and changes in labor legislation to attract more investments.

The banks, in turn, reserved the right to monitor the Peruvian economy to assure the completion of the targets agreed upon. The banks involved in the steering committee were Citibank, Bank of America, Chase Manhattan, Manufacturer's Hanover, Morgan Guaranty and Wells Fargo.

Shortly after receiving the loans the Peruvians made a "bargain" arms purchase from Russia for a sum approximately equivalent to the loan. Also the devaluation agreed upon and the subsequent price increases caused riots in the streets of Lima as well as in the provinces. Finally, the targets were not met. So at the end of 1976 fearing the "economic dominos" effect if Peru defaulted on its loans as well as the questionable practice of private banks putting conditions on a sovereign government, the banks sent Peru to the IMF.

C. IN SUMMARY

To sum up, it is clear that many factors contributed to and/or exacerbated Peru's indebtedness. Among them were the overly optimistic

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assessment (by all involved) of Peru's economic future in 1973, heavy borrowing on the part of the military, aggressive salesmanship on the part of the banks as well as their interference in the Peruvian economy, the world market, overfishing, and mismanagement on the part of the military as well as a weak government at the time of the crunch.

All of these factors are responsible for the debt, with the government playing a major role and the international banks a less major one. Although the spectre of the IMF policies served to dissuade the government from seeking it out and to assure the banks of a fallback position, it did not play any significant active role in the indebtedness of Peru.

Nor did the people. They neither sought out the loans nor were they consulted.

II. THE "STABILIZATION PROGRAM" OF THE IMF AND THE PERUVIAN GOVERNMENT

The formula agreed upon by the Peruvian Government and the International Monetary Fund in order to cancel the debt owed to the International Banks and Lending Institutions is basically the following:

1) Control inflation by controling the money supply and decreasing real wages.

2) Cut government spending especially welfare programs, including food subsidies.

3) Devaluate to encourage exports and restrain imports.

4) Rationalize the tax structure.

5) Eliminate nuisance taxes on imports.

6) Raise interest rate to encourage savings.

7) Encourage foreign investment.

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From the beginning let me state that my criticism of this program is not that it has caused Peru to go into debt. Rather my disagreement is with the program as a solution: while it has solved the problem of some, it has spelled disaster for the majority.

A. STABILIZATION

The program is most often called a stabilization program and for some people and institutions involved, it is that. But for whom has it meant stability? Fundamentally, it has stabilized the international banks who are now assured that their loans will be paid, albeit over a longer period. It has meant stabilization for those involved in the export market, primarily multinational corporations, but also some local entrepreneurs, specifically those who belong to ADEX (Peruvian Association of Exporters). Also, some of the larger corporations which deal with the internal market and can weather the storm, will reap benefits.

Finally, special mention should be made of those involved in the area of non-traditional exports who are the beneficiaries of the CERTEX, a tax exemption (around 30%) to spur new exports. Even such food staples as milk, chicken, and noodles benefit from the exemption. While local farmers were dumping up to 12,000 liters a day in the rivers around Arequipa because the internal demand had dropped due to price increases, at the same time Leche Gloria S.A. got a tax write-off to export the "excess." Noodles too are a "non-traditional" export. They bring an export price of approximately 56 soles a kilo (plus tax exemption) while in Lima they can't be bought for less than 90 soles a kilo.

B. CONSUMER: STABILIZATION EQUALS DESPERATION

This serves to point up the fact that the program agreed upon by the IMF and the Peruvian government, has not meant stabilization for the rest. The local industry which produces for the local market has been

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devastated, especially the small and middle businesses. For the consumer, stabilization equals desperation. Culturally and politically the program has meant chaos. I cite the words of Bishop Dammert of Cajamarca, universally respected for his intelligence and pastoral sensitivity:

> "The demands of the International Monetary Fund. . .have produced hunger, malnutrition of children, sickness, scarcity of work and education, in one word--Misery--for numerous Peruvians. Selfish interests predominate such as those who, seeing their profits decrease, abandon the country with their money and from afar boast of patriotism. Hatred is rampant, defaming people with impunity, distorting the facts on all levels of society. Far and wide in Peru one contemplates a 'non government' imposing its will by physical force but not possessing the authority of the people."

These are harsh words and they become harsher if we take into account that they are spoken by a man not given to strong language.

On the other hand, Linda Koenig the head of the IMF mission to Peru was summarized in the Latin American Political Report (Nov. 1979) as critizing the CERTEX on the one hand, while complaining that the government had been too generous in its wage increases on the other.

One wonders which language is harsher.

C. POLITICAL IMPLICATIONS

In the conversations which I've had over the past few months many have pointed out that the IMF is an apolitical institution. If by this it is meant that the IMF must be kept free of partisan politics, i.e., not favoring one nation or institution over another, it is a laudable goal. But that is politics in a very narrow sense. The word politics in its root sense means that which has to do with the life of the people. From this point of view, it is clear that the IMF is eminently political. Any institution which effects the dinner table, deals with the core of people's lives.

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Its political implications in the sense of the reaction of those people are very clear. And these reactions come to bear directly on the deliberations of this esteemed body.

In Peru, the policies of the IMF and the Peruvian government are seen as being at the service of the banks on the economic level. In the political sphere, they are seen as indirect instruments of American foreign policy. Whether one agrees with this judgment or not is moot. It is a political reality.

And there is some circumstantial evidence to reinforce this attitude. The United States delegate to the IMF has always sided with the majority even in the case of Somoza. He has the largest weighted vote; the IMF staff works out of Washington, etc.

Finally, I wish to quote from a letter from Secretary of the Treasury Blumenthal, written shortly before his resignation, to Javier Silva Ruete, Peru's current Minister of Finance. I ask you to hear the letter not from our socio-political context at that time, but rather from the position of the hungry Peruvian peasant and worker.

August 2, 1979

Dear Mr. Minister,

During my tenure as U.S. Treasury Secretary, it has given me great personal satisfaction to meet with you and develop with you close working relations in areas of key bilateral concern. It has been personally gratifying to collaborate in Peru's comprehensive efforts to stabilize its economy.

Peru has, indeed, made notable economic strides under your strong leadership. I wish you continued successes in the process which your government is taking in its program of economic reactivation. Together we have established a sound basis for a closer bilateral understanding on key economic and financial issues. I hope that this spirit of cooperation with Peru will continue to grow during the term of my successor, G. William Miller, as Treasury Secretary.

Sincerely,
W. Michael Blumenthal

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This letter seems to support what the Peruvian people consider the devastation of their lives. Before moving on, I want to make it clear that in the eyes of the Peruvian people, this in no way exonerates the Peruvian government from responsibility for the current situation. It just reinforces the opinion that there are others who support these policies. The political implications here directly effect the United States.

D. THE INSENSITIVITY OF THE IMF

My argument here is that the IMF is operating under false asumptions. It somehow believes that economics can be separated from life and people. I don't think that the people who work at the IMF intend that their policies create such havoc. I am sure that their intent is to stabilize the local economy. And I am sure that when they present their case, they will have substantial data to prove, indeed, that the Peruvian economy is well on the road to stability in macroeconomic terms. I do not debate this and I am sure we can agree that in great part this is due to world market prices on such commodities as oil, silver and copper.

My problem is that the IMF does not even take into account the human factor. I agree with the preliminary conclusions of the Brandt Commission as reported in the New York Times this past December 16th.

> ". . .the draft report contains a criticism of the International Monetary Fund for what the commission believes is the fund's overemphasis on balance-sheet considerations in evaluating a nation's credit worthiness.
>
> Commissioners are known to be sympathetic to the South's view that the fund has demonstrated considerable insensitivity to the social and political aspirations and needs of developing nations, whose access to private capital depends on a good credit rating from the fund."

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I would add that the fund seems to have been a good deal more sensitive to the international lenders.

There is a certain mystique which surrounds the fund. I must say I find it paradoxical as a man of religion that while the idea that religion can be separated from life was long ago debunked, I find that this is not true of economics, at least IMF economics. In examining IMF data tables, I found much which related to finances and balance sheets, etc., but found no data on nutrition, employment (although its first article specifically commits itself to increasing employment), real buying power or mortality rates, etc.

The aura surrounding the IMF proceedings (and bank loans) reminds me of the cloisters of old. There is a belief held by some that decisions made in this sanctuary work and should not be questioned despite substantial evidence to the contrary. Even language such as "austerity" and "stabilization" are products of a certain "apartness" from the reality lived and experienced by the people of Peru and other third world nations. To eat chicken feed is not austerity. Constant hunger does not make for stability.

It has been argued, furthermore, that it is the local government which decides how to reach the goals and that the IMF only sets the goals. The IMF staff, however, reviews the program every three months and continues to agree to the program presented by the government despite the human deprivation which results. Agreement implies accepting responsibility for the results (good and bad).

I do not disagree with the need for a program of stability. It is necessary. But a program which does not take into account human

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beings when its decisions are of vital importance to these very human beings is not amoral as some might imply. It is a program which deals with the very essence of morality--bread and life.

E. CHANGES NEEDED

What we need is a program which effectively takes into account human needs and assures that they be met. The present program does not do that and must be changed.

Finally, the responsibility (or lack thereof) of the banks must be addressed and controlled.

We can no longer support a program which adds two plus two and comes up with two loaves of bread for those most in need.

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CENTER OF CONCERN—
FOCUS: TOWARD A WORLD THAT IS HUMAN

3700 13th Street, N.E.
Washington, D.C. 20017
(202) 635-2757

February 1980

Fr. Thomas Burns M.M.

Dear Tom:

This present note conveys impressions about the reaction of missionaries I met on a recent three week visit to Peru to the impact of IMF conditionality on the poor of that country.

Those impressions were decidedly negative. In general at least fifteen missionaries told me that acceptance of IMF conditionality for stabilization had deepened unemployment, brought widespread malnutrition, a high increase of infant mortality.

I then tested these reactions on four Peruvian economists(I myself am an economist) and two American economists. Their convictions lay in the same direction as that of the missionaries.

This did not really surprise me for a growing number of U.S. "mainline" economists are coming to the same conclusions for reasons set forth in a couple--only a sample--of articles I have brought to your attention.

But to return to the missionaries. Infant mortality concerned them above all else You have heard the figure of " 500,000 IMF-caused deaths " That comes from the Governor of the Peruvian National Bank. I heard that statement from some missionaries. More generally they sought only to convey that austerity had brought in its wake a tragic increase in infant mortality. How so? As they put it, the cutting out of government food subsidies put basic foods out of the reach of thousands. In addition, because their reduced incomes(from unemployment and under-employment and the general 30% reduction in real income) made them an unattractive market for food suppliers. The latter turned to exporting milk, wheat, potatoes, sugar to neighboring Bolivia.

I went into several stores and asked why infant-formula food and canned milk was piled high. The uniform answer was that the people couldn't afford to buy them. Another storekeeper told me that anyday I could see trucks carrying food past Lake Titicaca into La Paz.

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I talked with a nurse in a clinic. She told me the crowds of sick I saw at her doorstep could not afford to buy medicines. They are dying people, she added Another, a sister, told me up in an Indian settlement our people aredying. Let the IMF s theories face that condition " In Ciudad De Dios, a poor barrio of Lima another sister told me(others elsewhere confirmed this)that tuberculosis was more rampant than at any time in her life in Peru."Its due" she added, to malnutrition as are still other diseases that have cropped up virulently in the last few months.

Still another missionary told me of seeing where she worked a pile-up of fourteen infant coffins--wildly beyond anything she had ever seen. That was confirmed by a missionary doctor-surgeon. He told me that the government has no idea of the number of infant deaths(and other) simply because people are too poor to afford registration of death or burial in a cemetery. "clandestine" cemeteries are creeping up everywhere." Missionary priests attested the extraordinary number of people coming to ask the Last Anointing" for their dying ones.

In many poor barrios. I saw people, even kids, scavenging in refuse heaps for scraps of food. I also saw that phenomenon of poverty in Lima the thousands upon thousands who are reduced to trying to sell anything in the desperate hope of bringing home a a bit of money. I walked dozens of blocks through hordes of these sellers competing against one another for the bit of trade that passed their way.

You will note in the preceding paragraphs that I have given no attention to other manifestations of poverty which are the tragic normality of Peru's masses. I have confined myself to "new" poverty which was identified as IMF-induced.

It does not serve my present purpose to narrate conversations with Peruvian and other economists Suffice it to say that they run largely in terms of the articles above referred to. True, Peru has had a dramtic turnabout in its external balance of payments A U.S Embassy report stated this as owing to the IMF's stabilization plan and as"having been met easily by Peru." In fact all the evidence seems to verify that the turn about was due to an upward trend in world prices for copper gold, silver, wool as well as Peru's handsome earnings from export of oil. But this (for the reasons given in the above-mentioned literature has thus far meant no improvement in domestic production and employment.

The case for an improvement in IMF lending to many Third World countries is in my judgment overwhelming.

Philip Land
Associate, Center of Concern

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Some pertinent quotes on health and infant mortality.

April 1978 Development Assistance Program US/AID Peru

"A recent analysis done by US-AID Peru indicates that annual per-capita income in Peru has been declining rapidly since 1974 from $830 to as low as $516-570 in 1978, and will continue to fall further in the next few years"

"average infant mortality is 115 per thousand"

"life expectancy is 56 years"

January 1979 AID Country Development Strategy Statement FY 1981, page 5

"Peru's health problems are more severe than the Latin American average; child and infant mortality are high and result from a high incidence of malnutrition in the country's poorer regions Nearly half (48.4%) of all deaths occurred in children under 5 years of age and 60% of these are due to malnutrition related diseases. Average infant mortality is 142 deaths per thousand live births, rising to an appalling 200 per thousand in the southern sierra Nationwide, 172 children out of every thousand die before age 2. In the most deprived aregions of the sierra that figure rises to 300 of each thousand life expectancy is age 52. In 83 of Peru's provinces it is less than 50, and in 14, less than 40."

In the Jan. 9 "Expreso", Dr. Ernesto Salem, spokesperson for the [illegible] Medical College of Peru (Colegio Medico del Peru), expressed his indignation that only 3.8% of the Budget will go for health in 1980, in light of high infant mortality and sickness which are the result of malnutrition He also claimed the National Health Fund (Fondo Nacional de Salud) has received only a fraction of the money budgeted to it in 1979.
(Source: Desco Jan. 1980)

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Uganda War Broke Tanzania's Treasury but Not Its Spirit

By GREGORY JAYNES
Special to The New York Times

DAR ES SALAAM, Tanzania, Dec. 14 — War with Uganda broke this country, sucked away its foreign exchange reserves and set it behind 8 to 10 months in payments to foreign creditors. Shortages are everywhere. Butter, cooking oil, flour, gasoline, rice and sugar come at a premium, when they come at all.

And yet last month, Tanzania summoned its firmest socialist resolve and told the International Monetary Fund to think again if it thought the country would compromise its ideology for 300 million desperately needed dollars.

A team of negotiators for the I.M.F. left and the $300 million will not be coming because Tanzania balked at the "standard package" of proposals, which included cutting Government spending and social services, ending price controls, devaluing the currency and increasing domestic bank lending rates.

President Julius K. Nyerere said:

"People who think Tanzania will change her cherished policies of socialism and self-reliance because of the current economic difficulties are wasting their time."

The country's Minister of Finance, Edwin Mtei, who had been inclined to accept the fund's requirements, got the point and resigned.

Uganda War Cost $500 Million

So Tanzania rolls along, resolute in the face of figures that would mortify most economists. The war, which began in October 1978 and ended with the fall of Kampala in April, cost this country $500 million. At the outset, Tanzania had $280 million in foreign exchange reserves. The reserves fell quickly to about $50 million, the emergency level for working capital.

Tanzania ran through its lines of credit, getting about $200 million in loans from around the world. Then it turned to supplier credits, piling up $200 million in debts for imports. All the while a balance-of-trade deficit grew to enormous proportions. This year, the country imported $1.1 billion in goods and earned $450 million in exports.

The country stays afloat with $600 million a year in foreign aid and, in the words of an economic analyst here, by "not paying their bills."

"They keep current on their relations with overseas banks," he said. "But debts to foreign suppliers stretch back most of this year. People are queuing up for payments, but they keep extending credit, thinking they will be paid with foreign aid, which is probably true."

Reached Commercial Credit Limit

Tanzania has reached its limit with commercial credit. The country had been hoping that if the I.M.F. loan was approved, private banks would consider the show of confidence and allow more commercial borrowing.

The dispute with the fund also upset a confidential appeal to nine nations, including the United States and Britain, for $320 million that the Government said it had to have to avoid economic collapse. The aid hinged on the I.M.F. recommendations and was to be channeled through the World Bank. "But now," a Western diplomat told a local journalist, "we're not prepared to enable Tanzania to go over the head of the I.M.F."

"The I.M.F. is not hungry for clients," said another diplomat. "The I.M.F. has said, 'You call us when you want us.' Hopefully, talks will be reopened at some point."

Meanwhile, gasoline is sold in Tanzania only four days a week, and there is a ban on driving Sundays after 2 P.M.

"For sugar, flour, that sort of thing," says an Indian merchant in Dar es Salaam, "everyone has a friend of a friend of a friend who procures. It is virtually impossible to find anything at the Government control price. Flour, for example, is supposed to be 20 of your American cents a pound. I have just paid nearly one dollar."

Problems Seen as Short Term

A Western economic analyst believes the Tanzanians "see their problems as short term." He said: "All they want to do is borrow the money to pay off the obligations, then in some general way get on with development. Their plans are very, very ambitious. Hydroelectric power. Port expansion. Universal primary education. A new airport for Dar es Salaam. And at the same time they want to keep importing to keep things running and to increase defense spending. It's boggling."

Pessimistically, the economist does not see Tanzanian socialism working because of what he calls a lack of the basic installations and facilities for growth and an inadequately trained work force.

A Western diplomat takes a brighter view. "This is not in any way a luxury oriented culture," he said. "Tanzania has a great capacity to carry on. It doesn't fall apart when things go wrong. Hitting on two cylinders out of eight, it still works."

A close friend of President Nyerere feels essentially the same as the diplomat. "Politically we are strong," he said. "People accept the stringencies. Our socialism, honestly, is the only thing holding us together."

In a paper on the economy, Kighoma Malima, an economist here and head of the ruling party's Planning Committee, wrote that the historical evidence "indicates that the country has always readily and willingly sacrificed any external economic assistance if such assistance would have made Tanzania compromise her independence and nonalignment as well as her unflinching support to the liberation struggle."

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Christian Science Monitor - 10/18/79

From the media

The hazards of aid from the IMF

Khartoum, capital of the Sudan, has recently been the scene of intermittent rioting and demonstrations following drastic increases in the prices of some basic commodities, including gasoline, flour, and sugar. Workers on the crucial railroad system have gone on strike and, until recently, farmers were refusing to plant next season's cotton crop, the main source of foreign exchange. The cause of these disturbances seems very similar to that of the 1977 riots that broke out in Egypt in protest at sudden food price increases. Both countries were imposing measures approved by the International Monetary Fund.

Egypt has more severe problems than Sudan. But like Sudan, Egypt was having great difficulties with foreign debt.

Egypt's relationship with the International Monetary Fund follows a pattern fairly familiar among impoverished developing countries. In 1976, the IMF imposed borrowing conditions that were considered unnecessarily harsh and included the reduction of subsidies. The riots in January, 1977, were the result.

A new relationship between Egypt and the IMF was then worked out. Egypt was to receive the equivalent of $750 million over three years. It got an initial portion of $30 million on the signing of the agreement in August, 1978, but has not received others subsequently because it has failed to keep to the agreement. For the moment, the IMF has virtually abandoned one requirement – the reduction of direct and indirect subsidies, which have coincided with the budgetary deficit.

The experiences of Egypt, and now Sudan, show there are political limits to a program of economic orthodoxy supported by the IMF. In Sudan's case it may be questioned whether all the economic targets on which the IMF has insisted are even attainable.

Neither the interests of borrowers nor the IMF are likely to be served by the government of a recipient state being brought down for doing what has been suggested by the IMF. But there remains the problem of who should be the judge of what is politically as well as economically viable.

– Financial Times World Business Weekly

THE WALL STREET JOURNAL, Monday, Dec. 3, 1979

Bolivia Announces Measures to Tackle Economic Problems

Special to THE WALL STREET JOURNAL

LA PAZ, Bolivia – Bolivian President Lidia Gueiler announced a broad package of economic measures to tackle the nation's staggering economic troubles.

The package includes a 20% devaluation of the peso, a price freeze on some food staples and pay raises for most workers.

The devaluation cut the Bolivian peso's rate to about four U.S. cents from five cents, and the central bank has authority to adjust it further. The move has long been advocated by the International Monetary Fund, though some sources indicated the agency would have preferred a 50% cut. A further cut is possible, they add. The peso most recently was devalued in 1972.

The government also raised the maximum allowed interest charge on loans to 19% from 16%. Interest rates on savings also were allowed to rise. But banks will be required to deposit all their checking and savings account dollars with the central bank, instead of 48% as previously required. Reserve requirements for pesos were cut.

Reaction to the package was mixed. One foreign banker said the moves weren't "harsh enough" to deal with the nation's economic woes but the package could bolster the economy "if the government can enforce them."

The Federation of Bolivian Labor Unions voiced strong opposition contending that "wage increases (of up to $40 a month) wouldn't cover the increases in the cost of living." The group has called for a nationwide protest Wednesday but has refrained from calling a general strike. The bakers union, however, has gone out on strike.

Bolivia has one of Latin America's weakest economies. The nation carries foreign debt of nearly $3 billion, and more than 40% of its export earnings are needed just to service the debt. The nation expects a $222 million international payments deficit this year.

President Gueiler did receive some encouraging news after announcing her plans. The IMF announced a $150 million aid program. Venezuela promised an immediate $20 million loan and the U.S. pledged an additional $12 million of food.

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THE JOURNAL OF COMMERCE, Wednesday, January 30, 1980

Peru to Buy Wheat, Seek Credits in DC

By
A. KOFFMANN O'REILLY
Journal of Commerce Staff

LIMA, Peru — Top Peruvian financial officials, led by Economics Minister Javier Silva Ruete, plan to seek credits and buy wheat while touring Washington's government and international financial circles starting the end of this week.

The wheat will be bought under the facilities provided by the United States PL-480 program and the Commodity Credit Corp.

Compared with the frantic missions Peru used to send to Washington, this mission will be a breeze. Peru's external accounts are showing a dramatic turnaround as this country emerges from the crisis that brought it to the edge of bankruptcy two years ago.

But the improvement has not been matched in the domestic economy. High unemployment and accelerating inflation are the continuing concerns of most Peruvians as they get ready to return to democracy and elect a civilian president within four months.

Exporters' profits, however, such as those of silver producers enjoying booming metal prices, are beginning to trickle back and increase domestic demand providing oxygen for the local industry.

Peru's gross national product grew last year by 3.7 percent, according to official estimates. Although this rate of growth is unsatisfactory by Latin American standards, at least it confirms that the country is on the way to recovery from several years of gross national product declines.

The extent of this recovery is subject to debate, with officials and industrialists expressing opposing views about it, and the electoral campaign has proceeded in a strained economic atmosphere.

Surprisingly, major candidates in the presidential race — the first after 12 years of military rule — haven't yet announced specific proposals to help the lot of the impoverished majority of 17 million Peruvians.

In fact, candidates have refrained from making political hay out of Peru's "stagflation."

It's not clear whether their restraint is due to adroit maneuvering by outgoing President Gen. Francisco Morales Bermudez or to their failure to come up with alternatives to the International Monetary Fund-sponsored economic austerity program currently being enforced here. But an emerging consensus holds that regardless of who wins the election at least the broad lines of the economic policy will remain.

Observers who can keep track of Peru's 86 political parties agree that the winner in May will be either ex-president Fernando Belaunde Terry, a right-of-center Social Christian believed to be an advocate of foreign investment in general and U.S. investment in particular, or Armando Villanueva del Campo.

Mr. Villanueva replaced the late Victor Raul Haya de la Torre as leader of the Popular American Revolutionary Alliance, which once was regarded as a leftist party.

This by now is a middle-of-the-road party with leftist memories. It is the largest single political party in Peru.

But the presidential race is crowded. In the event that no candidate gets at least 36 percent of the vote — which recent polls in this metropolitan area indicate is a likely result of the May elections — Congress would be called upon under the new constitution to elect the president. Congress is not limited to choosing from among the candidates and it could re-elect General Morales.

Political uncertainties ahead however, worry businessmen less than the financial uncertainties of less than two years ago worried them as well as government officials and international bankers.

International bankers had cause to worry about an imminent Peruvian default on the payment of its close to $8 billion external debt service. Besides the direct impact on the banks' own Peruvian exposure it was feared that such a default would have a "domino" effect as Zaire and Turkey were also suffering similar crises.

A decline in the prices of Peru's mineral export staples and delays in the availability of exportable oil surpluses were some of the factors behind the Peruvian crisis. The reversal in that price trend and the appearance of Peruvian oil in the world's spot market explain most of the improvement in Peru's external accounts.

"The economic situation was grave." Economics Minister Javier Silva Ruete recalled.

"Back in May of 1978 the gross national product had been declining four years in a row, the trade balance was in the red also for the fourth time and the fiscal deficit was 9 percent of the gross national product. Inflation was projected at 100 percent for the year. Net reserves stood at minus $1.25 billion and the private sector had unpaid debts of another $250 million, and all of this took place in a climate of political crisis," Mr. Silva said.

"We will turn the country over to the new administration with $350 million in reserves, with both the trade and the payment balance showing a surplus and with the GNP not only growing, but growing faster than the population's 3 percent annual growth rate," he added.

"We have started to reduce the unemployment rate that stands at 8 percent and the underemployment rate of 45 percent.

"We hope that the economic improvement translates into a bettering of the social situation after the May elections," stated the minister who has close personal ties with Alan PAA personalities.

Industrialists, however, hold less optimistic views on the Peruvian recovery.

"We are hoping for recovery signs, but we don't see them," said Alfredo Ferrand, president of Peru's industrialists association.

"Industry was affected in previous years by inflation and the lack of international reserves in the country. Internal demand fell by one-third as salaries' buying power fell between one-third and one-half," added the spokesman of 85 percent of the capital invested in industry in Peru, as Mr. Ferrand described him.

"Recovery is very slow, particulary for the industries that were most affected, such as the automotive and the construction sectors with the related industries as well as those that couldn't find export markets for their production," he said.

Mr. Ferrand, who estimates unemployment at 20 percent, said that Peruvian industrialists are now facing higher utility bills "as the government is trying to eliminate its deficit by giving state-owned utilities larger profit margins by raising their prices although their costs are already high." The government should increase the utilities' efficiency rather than profits allowing them to pass on their higher costs, Mr. Ferrand indicated.

(Continued)

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Peru

He charged the government with being the head runner in the inflation race. Last year inflation reached 66.7 percent here, despite the official inflation goal of 40 percent.

"For if official hopes of a faster recovery after the May election come true — private investment here tends to perk up after an election and slow down before it — it will be none too soon for most Peruvians to start improving their lot.

The IMF-sponsored austerity program enforced by Mr. Silva and a team of other civilian economists cost blood and tears to the Peruvian people.

Peruvians were under a state of emergency from early 1977 until late 1978 as successive economic ministers failed to get the backing of the armed forces to reduce government spending and face up to the threat of default.

But even the half-way measures taken were met with labor resistance. Tens of Peruvians died in the ensuing demonstrations. Unemployment rose and salary increases were below the inflation rate.

The IMF-Silva Ruete austerity policy that has been upheld since May of 1978 included the elimination of subsidies on foodstuffs and other essential items as well as measures to correct Peru's external performance.

But it was a hard pill for Peruvians to swallow. A United States Agency for International Development study conducted in May of last year estimated that between 430,000 and 1.14 million people in Lima suffered from severe nutritional inadequacy. It was reported later last year Caritas-Lima, a Roman Catholic relief organization that distributes U.S. food aid, estimated that 60 percent of greater Lima's 4.5 million people suffer malnutrition.

Although inflation will continue afflicting Peru this year, government officials expect to contain it at around 50 percent.

"We already have imposed a 92 percent reserve requirement on the banks' loans in local currency and a 100 percent reserve requirement on dollar loans. So we have practically run out of monetary anti-inflation measures," admitted Alvaro Meneses, head of the Banco de la Nacion.

"I am afraid that inflation could accelerate during the second half of this year because of psychological reactives of the people.

"The profits from exports by the private sector will be invested and the economy will enter a period of fast growth. We see all the signs of that.

One can hardly find an architect available in Lima these days. That means that a construction boom is about to start and there are two sides to that coin: it means economic recovery and more employment, but it also pushes up inflation," Mr. Meneses said.

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THE NEW YORK TIMES, DECEMBER 16, 1979

Brandt Panel Weighs Pact by Rich and Poor Lands

By JUDITH MILLER
Special to The New York Times

WASHINGTON, Dec. 15 — An international commission headed by former Chancellor Willy Brandt of West Germany is weighing a proposal calling on oil-producing and oil-consuming nations to reach an accord to assure their economic stability and development.

The independent commission, whose 19 members represent a broad political spectrum, are meeting at Leeds Castle, England, to agree on the final draft of a report for the United Nations on how a more equitable relationship between rich and poor nations can be established.

If the commission calls for such an accord, it would be the first consensus of its kind reached in the context of what is known as the North-South dialogue, a frequently acerbic exchange of complaints and demands by poor and wealthy nations.

Although the details are still being worked out, sources close to the commission say that the proposals would urge producers to agree not only on a specific price for oil, but also on a steady rate of supply to industrialized and developing nations. For their part, consuming nations would agree to some sort of medium-term linking of oil prices to the cost of goods bought by the producing countries, which would, in turn, protect the agreed-upon oil price against inflation. In addition, consumers would adopt meaningful conservation targets.

The consensus on the importance of an accord, sources say, is very fragile and might well disintegrate before the commission can issue its final report in March. However, the commission's deliberations and present consensus are bound to intensify a debate already under way among the Carter Administration policy makers.

Some officials at the State Department, Treasury and White House are known to favor a bold new initiative in international energy matters, which the producer-consumer accord being weighed by the commission would represent. Another possibility examined by both the United States and the Brandt panel would treat oil more as an international commodity, like coffee, cocoa or sugar, where stocking arrangements are used to moderate price fluctuations.

The commission, which Robert McNamara, president of the World Bank, helped found, is independent of the bank and any government. It is based in Geneva with a staff of about 12 and an annual budget of $1.5 million.

The underlying theme of the commission's preliminary report is recognition of the mutual economic dependence of the North and South and the need for what Mr. McNamara once described as a "global compact."

The commission, for example, is expected to endorse the need for additional aid to poor nations by oil-producing and developed nations through "jointly shared guarantees." While the vehicles for such assistance have not been specified, there is a consensus that private banks will be unable to handle the rapidly growing debts of developing nations brought about by increases in oil prices.

The commission is also expected to condemn the growing layers of protectionist laws and regulations that hamper the free flow of trade. In addition, the draft report contains a criticism of the International Monetary Fund for what the commission believes is the fund's overemphasis on balance-sheet considerations in evaluating a nation's credit worthiness.

Commissioners are known to be sympathetic to the South's view that the fund has demonstrated considerable insensitivity to the social and political aspirations and needs of developing nations, whose access to private capital depends on a good credit rating from the fund.

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Chairman NEAL. Thank you very much.

Reverend Chauncey, we would like to hear from you at this time.

STATEMENT OF THE REVEREND GEORGE A. CHAUNCEY, CHAIR, INTERRELIGIOUS TASK FORCE ON U.S. FOOD POLICY, ACCOMPANIED BY TIM ATWATER, TASK FORCE STAFF

Reverend CHAUNCEY. Thank you, Mr. Chairman.

I am accompanied by Tim Atwater on my left of the task force staff. I want to summarize the main points of the statement we have submitted and make a few additional comments.

First, a word about who we are and why we are interested in the IMF. The Interreligious Task Force on U.S. Food Policy is a coalition of more than two dozen national Protestant, Roman Catholic, Jewish, and ecumenical agencies who work together in an effort to secure bread and justice for all members of the human family. We have been working together on the problem of world hunger for over 5 years.

One thing that we have learned in 5 years of work on world hunger is that you are never going to solve the problem of world hunger by focusing on hunger alone. If you are really concerned about hungry people, you have got to be concerned about the poverty of which hunger is but a symptom. And if you are really concerned about the poverty of people, you have got to be concerned about those social structures and institutions and systems which so dramatically affect the lives of the poor.

And thus it is that, beginning with simple human compassion for the children of the Third World, the task force has become concerned about so complex an institution as the IMF. We are not experts and do not pretend to be experts in the intricacies of the operation of the Fund. We readily confess that there are many things about the Fund that we do not know. Moreover, we are not economists, though we observe in passing that economists seem to be almost as divided in their dogma as are the theologians, and that expertise in economics seems no more a guarantee of truth and wisdom than does expertise in theology.

More importantly, we hold that there is no such thing as a purely economic policy or an exclusively economic institution. All economic policies and institutions are also moral policies and institutions, in that they affect persons and the relationships among persons. Economic policies and institutions, no matter how apolitical they pretend to be, inevitably make an impact on people.

We are convinced that one way to judge the moral worth of any economic policy or any economic institution is to consider its impact on the poorest and weakest members of the human community. That is the other reason the task force is concerned about the IMF.

We have become convinced in our studies that in its current operations the IMF all to often contributes to the increase rather than the amelioration of the suffering of the poor and weak. We are convinced that a major restructuring of the IMF is morally imperative and that the United States, as a leading member, should provide leadership in the move for reform.

The IMF has become perhaps the most powerful economic institution in the world today. The source of this power is not the

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financial resources of the Fund, but the confidence placed in the Fund by the governments of the industrialized nations and the banking community. It is now accepted practice for both governments and private banks to make their loans to developing countries contingent upon the borrowing countries' coming to an agreement with the IMF on an economic plan to alleviate its balance of payments difficulties.

As the debt burdens of the poor countries worsen, IMF prescriptions become increasingly severe. Typically, the adjustment programs agreed to by the Fund and the government include such steps as devaluing the currency, controlling the rate of expansion of the supply of money, reducing government spending, imposing wage controls, raising interest rates to encourage savings, increasing taxes, and reducing or dismantling barriers to foreign private investment and to free trade in general.

All too often, these agreements result in seriously worsening situations for low income people. The monetary and fiscal policies strongly encouraged by the IMF frequently make operating capital inaccessible to small business owners and small farmers. Wage controls without price controls often erode the already marginal living standards of the working poor. Cutbacks in spending for essential social services, such as housing and health care and supplemental feeding, often severely affect the majority of the population.

I will not spell out in detail the human costs of such programs. Father Burns has spoken eloquently to these out of his direct and personal experience. I will simply call your attention to some news clippings that we submitted to you: the New York Times report that in the last 4 years, for example, the workers' buying power in Peru has been cut in half, the price of a loaf of bread has jumped, the number of babies who died before they can learn to walk has jumped some 30 percent.

Are such programs, so costly in human terms, the only possible solutions to a balance-of-payments crisis? We think not. At least two alternative programs commend themselves:

First, the IMF and local governments could determine to protect the lives and the livelihood of the poor majority. Cuts in government spending could be made in ways that minimize the negative effects of such reductions on the poor. Military spending could be reduced. More progressive taxation could raise government revenues. Essential consumer goods could be subsidized and luxury goods, especially imports, heavily taxed.

The IMF could and should encourage such policies. One way the Fund could do this would be to add to its economic performance criteria such items as maintaining employment at reasonable rates, maintaining real buying power, reducing infant mortality. Such criteria seem to us to be just as important and just as valid in measuring how an economy is functioning as are the criteria the Fund now uses.

Second, the Fund and the international community on the whole could give much more attention to the structural causes of Third World debt. These include terms of trade which are chronically unfavorable to developing countries, trade barriers that deny Third World products entry into the industrialized country markets, ever-

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rising oil prices, and the control by multinational corporations of most aspects of international trade.

To be sure, these structural problems fall, to a large extent, outside the mandate of the IMF. But to prescribe only internal austerity as the remedy for Third World debt, so much of which is caused by external factors, is surely to miss the mark.

In his testimony Monday, Secretary Solomon complained that the IMF is like the doctor who is unjustly blamed for the patient's illness. If in fact the IMF has a physician's role to play in the world today, then it surely should do a more aggressive job of alerting the international community to some possibilities of preventive medicine.

Mr. Chairman, meeting basic human needs and promoting more equitable distribution of the benefits of development are now considered to be the cornerstones of development theory by most aid agencies, including the IMF's sister organization the World Bank. The IMF is not and ought not to become an aid agency. But surely IMF policies should complement the development strategies of the aid agencies and not counter them, as they so often do today.

Our conclusion is that a major restructuring of the Fund is called for. At least four steps seem imperative:

First, highest priority should be given to revising Fund policies so that human needs are protected. An initial step could be the passage of U.S. legislation instructing the U.S. Executive Director for the Fund to work for the adoption of more reasonable and human needs sensitive economic programs, and to vote against Fund loans conditioned on the adoption of economic programs that would result in serious deprivation and suffering among the poor.

Balanced budgets and international payment accounts, however important, should never be achieved at the cost of malnutrition, severe unemployment, and widespread disease. Second, Third World governments should be given increasing voting strength in the Fund. While the Fund should retain a weighted system of votes reflecting the various size and strength of national economies, simple justice mandates that representatives of two-thirds of the world's people have a significantly larger say in the operation of so powerful an institution.

Third, Fund staff missions should be supplemented with representation from groups reflecting broader perspectives.

And finally, the debt burden of the Third World should be eased through increased balance-of-payments lending by public institutions. At a minimum, this should involve longer debt repayment periods for the poor developing countries and substantially lower interest rates. Moreover, the Fund's standby arrangements should be extended for a longer period.

The reforms we are proposing are similar, we understand, to those that will be made by the Brandt Commission when it releases its report next week.

Reforming the IMF would by no means solve all of the problems connected with Third World debt and balance-of-payments deficits. Similar efforts must be made on many other fronts as well. Reforming the Fund, however, would provide badly needed relief for millions of hard-pressed poor people. It could be a pivotal step toward fashioning a more just, equitable, and compassionate eco-

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nomic order. And it could strengthen the commitments of national governments to meeting human needs, protecting human rights, and increasing self-reliance.

Thank you, Mr. Chairman.

[Reverend Chauncey's prepared statement with attached articles re the International Monetary Fund follow:]

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INTERRELIGIOUS TASKFORCE ON U.S. FOOD POLICY

110 MARYLAND AVENUE, N.E., WASHINGTON, D.C. 20002

Statement by the Rev. George A. Chauncey
Chair, Interreligious Taskforce on US Food Policy
on the International Monetary Fund
before the
Subcommittee on International Trade, Investment and Monetary Policy
Committee on Banking, Finance and Urban Affairs
US House of Representatives
February 6, 1980

I am George Chauncey, Director of the Washington Office of the Presbyterian Church in the US and Chair of the Interreligious Taskforce on US Food Policy. The Taskforce welcomes this opportunity to offer testimony on HR 5970, authorizing an increase in the US quota in the International Monetary Fund (IMF).

The Taskforce is a coalition of more than two dozen national Protestant, Roman Catholic, Jewish, and ecumenical agencies who seek together to secure bread and justice for all members of the human family. Our very existence reflects the widespread concern in the American religious community for the world's poor and hungry people, and the widespread conviction that one way in which we in the religious community are obligated by our religious faith to seek justice for our needy neighbors is through addressing those public policies which have such an impact--for good or ill--on the life and well being of our neighbors.

In offering this testimony, the Taskforce speaks for itself and not for the two dozen religious bodies who participate in its work; but our testimony is consistent with public policy recommendations adopted by major religious bodies.

One thing we have learned in over five years of intensive work on the problem of world hunger is that the human community will never overcome or significantly reduce world hunger by focusing on hunger alone. If one is deeply concerned about the plight of hungry neighbors, one must also be concerned about the poverty of which that plight is but a symptom; and if one is deeply concerned about global poverty, one must be concerned about those social structures, systems, and institutions which either ameliorate or perpetuate poverty. Thus beginning with simple human compassion for malnourished children in Turkey, Peru, or Jamaica, we find ourselves worried about so complex an institution as the IMF.

THE TASKFORCE IS A TEAM OF WASHINGTON-BASED STAFF OF NATIONAL RELIGIOUS AGENCIES. THESE BODIES OR THEIR PROGRAM BOARDS COOPERATE IN ITS WORK: AMERICAN BAPTIST CHURCHES, USA ● AMERICAN JEWISH COMMITTEE ● AMERICAN LUTHERAN CHURCH ● BAPTIST JOINT COMMITTEE ON PUBLIC AFFAIRS ● CHRISTIAN CHURCH (DISCIPLES OF CHRIST) ● CHRISTIAN LIFE COMMISSION OF THE SOUTHERN BAPTIST CONVENTION ● CHURCH OF THE BRETHREN ● EPISCOPAL CHURCH ● FRIENDS COMMITTEE ON NATIONAL LEGISLATION ● JESUIT CONFERENCE ● LUTHERAN CHURCH IN AMERICA ● LUTHERAN CHURCH - MISSOURI SYNOD ● MARYKNOLL FATHERS AND BROTHERS ● MORAVIAN CHURCH IN AMERICA ● NATIONAL COUNCIL OF CHURCHES ● PRESBYTERIAN CHURCH IN THE US ● REFORMED CHURCH IN AMERICA ● UNION OF AMERICAN HEBREW CONGREGATIONS ● UNITARIAN UNIVERSALIST ASSOCIATION ● UNITARIAN UNIVERSALIST SERVICE COMMITTEE ● UNITED CHURCH OF CHRIST ● UNITED METHODIST CHURCH ● UNITED PRESBYTERIAN CHURCH IN THE USA ● BREAD FOR THE WORLD ● CENTER OF CONCERN ● NETWORK. THE TASKFORCE, WHICH SPEAKS FOR ITSELF, PROVIDES INFORMATION AND RECOMMENDATIONS ON U.S. FOOD POLICY TO ITS COOPERATING AGENCIES AND TO THE NATIONAL IMPACT NETWORK.

George A. Chauncey Presbyterian Church in the US Chairman

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We are not and do not pretend to be experts in the intricacies of the operation of the Fund, and readily confess that there are many things about the Fund which we do not know. But we have tried to do our homework carefully and have sought and received the counse of professional economists in the preparation of this statement Moreover, we are aware that al economic institutions have moral value ust as all economic theories reflect moral assumptions about what is good and right and we are convinced that one way to ascertain the moral worth of any institution--no matter how intricate--is to consider ts impact on the life and well-being of the weakest and poorest members of the human community.

We are concerned about the IMF because we believe that in its current operation the Fund all too often increases rather than ameliorates the suffering of vast numbers of poor people in the world. We are convinced that a major restructuring of the Fund is morally imperative; and that the United States, as a major member of the Fund, should provide leadership in the move for reform.

In this testimony, we seek to do six things (1) to examine the problem of Third World debt, a major problem which the Fund seeks to address; (2) to indicate the power of the Fund over poor nations in debt 3) to examine typical prescriptions of the Fund for addressing the problem; (4) to show the impact of these typical prescriptions on the poor and weak; (5) to suggest alternative approaches to the problem which seem to us more responsible; and (6) to draw conclusions from this analysis.

The Problem of Third World Debt

More and more developing countries find themselves facing severe balance of payments difficulties. Huge increases in the costs of imported oi have, of course, been a major factor. An equally important factor has been increased prices for imported manufactured goods, many of which are critically needed in the development process. By and large the prices of manufactures fully incorporate the increased cost of oil. Developing country exports, on the other hand, are still predominantly composed of primary commodities--the prices of which are subject to severe and unpredictable fluctuations. With relatively few exceptions, the purchasing power of Third World commodity exports has declined significantly over the past few decades.

One of the frequently cited answers to this problem of declining purchasing power has been for developing countries to diversify their economies, primarily by increasing their exports of manufactured goods. While a few developing countries, mostly in Southeast Asia, have enjoyed high rates of growth through this route, most developing countries have found that a multitude of tariff and non-tariff barriers exclude much of their production from developed country markets. And both commodity prices and the fledgling industries of the developing countries are often doubly vulnerable to uncontrollable international market forces, since the developing countries frequently lack domestic markets capable of absorbing their own production.

Against this backdrop of declining terms of trade and ever growing import bills, many developing nations have borrowed heavily. Such borrowing has been necessary to maintain consumption levels, finance development projects, and increasingly, pay off old debt While many of the poor developing countries continue to rely heavily on foreign aid funds, the relat vely more wealthy developing nations now borrow the major portion of their external capital needs from private commercial banks.

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Private banks, with huge "petrodollar" deposits on hand and faced with weak domestic demand, began lending heavily to developing country governments (and government-guaranteed enterprises) in the aftermath of the OPEC price hikes of 1973-74. While high level borrowing from private banks has enabled developing countries to maintain (in the short run) consumption and development that would otherwise have had to be cut back, it has also carried significant costs. Private bank lending is usually for considerably shorter periods than development aid loans, and inevitably carries higher interest rates. Hence the trend to private borrowing has contributed significantly to the Third World's mounting debt servicing costs.

The Power of the IMF

It in this context that the IMF has become perhaps the most powerful economic institution in the world today. The source of this power is the confidence placed in the Fund by the governments of the industrial countries and the banking community. It is now accepted practice for both governments and private banks to make their loans to developing nations contingent upon the borrowing country's coming to agreement with the IMF on an economic plan to alleviate its balance of payments difficulties. And as the debt burden of many of the poor countries worsens, IMF prescriptions become increasingly severe.

IMF Prescriptions

The exact details of IMF agreements are negotiated between IMF staff and debtor country official , with each having input into the final agreement. However, precisely because they are in debt and must succeed in negotiating an IMF loan in order to be considered credit worthy, Third World nations generally find themselves at a serious disadvantage in bargaining with the IMF Moreover because Third World negotiators often represent the elites in their countries, the impact of IMF agreements on the poor is often given inadequate attention. In any case, close similarities among IMF-endorsed economic programs in countries with widely varying political systems are readily apparent. Typically, the IMF insists that countries agree to take such steps as the following:

-- devalue their currency in an attempt to boost exports and restrain imports;
-- control the rate of expansion of the supply of money in order to dampen inflation;
-- reduce government spending, especially human services expenditures;
-- impose wage controls, while eliminating price controls;
-- raise interest rates in order to encourage savings;
-- increase taxes
-- reduce or dismantle barriers to foreign private investment and to free trade in general.

The Impact of the IMF on the Poor

All too often, the IMF's prescriptions result in seriously worsening situations for low-income people. The monetary and fiscal policies imposed by the IMF frequently make operating capital inaccessible to small business owners and small farmers, leading to higher unemployment and reduced food production. Wage controls without price controls erode the already marginal living standards of the working poor. Cutbacks in spending for essential social services (such as housing, health care, supplemental feeding programs, and education) often severely affect the majority of the population. Emphasis on increasing exports often comes at the expense of the domestic economy and consumers.

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A 1977 staff report issued by the Senate Foreign Relations Committee noted the IMF's impact in these words: ". .while the objectives of the Fund may be entirely apolitical, the consequences of fund recommendations can be highly political... (T)he steps a government has to take to carry out these recommendations can in many instances lead to heightened political tension and greater social unrest. In some countries, governments may have to resort to political repression in order to carry out such policies."

The Human Costs

An August 1979 New York Times article authored by a Catholic parish priest in Peru details the human costs of Peru's involvement with the IMF in graphic terms:

> The IMF formula to qualify for loans and credit is simple: Cut government spending, including subsidies for basic foods if necessary. Devaluate the currency to make exports more attractive and to discourage imports. Hold down wages to avoid inflation. But the social costs of this program, which the military Government implements and enforces, have been awful.
>
> In the last four years, the worker's real buying power has been cut in half. Only 45 percent of the 5 2 million in the work force have stable work. The price of bread has jumped 1 000 percent Per capita calorie and protein intake are but two-thirds of those listed by the Food and Agriculture Organization as the vital minimum.
>
> Nationally, the number of babies who die before they learn to walk has jumped some 30 percent, to 109 per 1,000. That translates into an additional 13,000 infant deaths a year. No one seems to notice. Children have a way of dying quietly. It's a massacre of the innocents.

Recent articles in the Los Angeles Times confirm and expand on this harsh picture:

> About a fourth of Lima's 4.5 million people were described in a recent survey as victims of "severe nutritional deficiency"--a nice way of saying they are starving.
>
> Mental and physical health problems rise as malnutrition advances. Researchers report a steady decline in the I.Q. scores of children in Lima's poorer districts, and doctors note a sharp rise in tuberculosis. a nutrition-sensitive disease A health team visiting a village of 5,000 people in northern Peru found that 80 percent of the households had at least one active case of TB.
>
> Peruvian Finance Minister Javier Silva Ruete the architect of the government s financial recovery program and the man who has instituted the IMF's tough austerity programs, recently admitted some hungry people have begun eating chicken feed in order to survive.
>
> "But what is more serious," Silva Ruete said, "is that there are people who do not even have that (chicken feed) food regularly."

In Turkey, a government headed by Bulent Ecevit agreed to an IMF program in July 1979 requiring sharp belt-tightening. The program was to be accompanied by an influx of IMF credit and Western aid. But, the New York Times reports, "The

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money has been slow in coming and the positive effects of the agreement are not visible." Opposition to the IMF program became a major factor in the subsequent downfall of the Ecevit government. Now an even more stringent set of policies is being negotiated with the IMF. According to the Times (December 15, 1979):

> The IMF's program could mean in the short term a drop in real income by half, according to independent economists.
>
> One million Turk earn a net salary of 5,000 lira, a little more than $100 a month, and have to spend half of that on rent. The balance is not enough to live on according to economic reports. Sociologists note that in the poorer quarters around Istanbul and Ankara, children are yellow from undernourishment.
>
> The IMF' current talks with the Government have been held in secret, apparently to avoid public debate. Even so, there have been protests against continuing the relationship.
>
> The State Planning Organization has questioned Turkey's relations with the IMF. In an official document...the Government department warned of "the gravest economic and social drawbacks of ties with the IMF, which it said would "radically change Turkey's development strategy."

Alternative Approaches

Are such programs--so costly in human terms--the only possible solutions to a balance of payments crisis? We think not. At least two alternative approaches commend themselves.

First, the IMF and local governments could determine to protect the lives of the poor majority. Cuts in government spending could be made in ways which minimize the negative effects of such reductions on the poor. Military spending could be reduced. Progressive taxation could often raise government revenues substantially. Essential consumer goods could often be subsidized in poor countries, while luxury goods, especially imports, could be heavily taxed to provide revenue and conserve foreign exchange. Governments could choose to assure reasonable access to credit for farmers and smal business owners even while setting higher interest rates for other sectors of the economy if necessary. Steps such as these can and should be supported by the IMF.

It is clear that the IMF is not without its own economic biases--most notably a tendency to prescribe rigidly free-market and monetarist solutions for any economic problem. For example the IMF nearly always opposes the use of import limitations of any kind in the name of free trade. This opposition continues in spite of the fact that unrestrained imports of luxury goods are a major cause of the trade imbalances (and hence, debt problems) of many developing countries. (A recent IMF staff report on Haiti actually applauds the Haitian government's decision to rescind import restrictions on luxury automobiles!)

Secondly, the IMF and the international community as a whole could give much more attention to the structural causes of debt. These include terms of trade which are chronically unfavorable to developing countries; trade barriers which deny Third World products entry into industrial country markets; ever-rising oil prices; and control by multinational corporations of most aspects of international trade, including shipping, processing of raw materials and marketing of both imports and

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exports. To be sure, some of the blame for unmanageable debt must be allocated to inexperience, mismanagement, and corruption on the part of Third World governments. Such problems are by no means uniquely applicable to the developing countries. Similarly, these structural problems fall, to a large extent, outside of the mandate of the IMF. But to prescribe only internal austerity as the remedy for Third World debt is clearly to miss the mark.

Meeting basic human needs and promoting more equitable distribution of the benefits of development are now considered to be cornerstones of development theory by the IMF s sister organization the World Bank. Yet IMF policies, rather than complementing the development strategies of aid agencies, generally result in increased human suffering and a widened gap between rich and poor.

Conclusions

A major restructuring of the IMF is called for. At least four steps seem imperative:

1) Highest priority should be given to revising IMF policies so that human needs are protected. An initial step could be passage of US legislation instructing the US Executive Director for the IMF to work for adoption of more reasonable and human needs-sensitive economic programs, and to vote against IMF loans conditioned on the adoption of economic programs that would result in serious deprivation and suffering among the poor Balanced budgets and international payments accounts, however important, should never be achieved at the cost of malnutrition, severe unemployment, and widespread disease

2) Third World governments should be given increased voting strength in the IMF. While the IMF should retain a weighted system of votes reflecting the varied size and strength of national economies, simple justice mandates that representatives of two-thirds of the world's people receive a significantly larger say in the operations of the world's most powerful international economic institution.

3) IMF staff missions should be supplemented with representation from groups reflecting broader perspectives. Inclusion of official non-governmental observers (such as labor, peasant, small business and church representatives) and perhaps representatives from other international institutions (such as UNICEF, the World Health Organization and the International Labor Organization) could help assure greater social sensitivity in IMF policies.

4) The debt burden of the Third World should be eased through increased balance of payments lending by public institutions. At a minimum, this should involve longer debt repayment periods, and for the poorer developing countries, substantially lowered interest rates. Additional funds could best be channeled through either a new international lending institution (such as the World Development Fund, reportedly to be proposed by the Brandt Commission) or through a reordering of existing institutions such as the World Bank and the various regional development banks. In either case, more equitable power sharing between rich and poor countrie and increased utilization of OPEC oil revenues and other balance of payments surpluses should be negotiated.

The reforms we are proposing are similar to those which we understand will be recommended by the Brandt Commission when it releases its report next week.

Reforming the IMF alone would by no means solve all of the problems connected

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with Third World debt and balance of payments deficits. Simultaneous efforts must be made to conserve energy, develop alternative energy sources, improve developing country access to industrial country markets, raise prices for Third World commodities, and help developing countries secure countervailing power in their dealings with multinational corporations. Reforming the IMF would, however, provide badly needed relief for millions of hard-pressed poor people. Moreover, reforming the IMF, an admittedly complex and difficult undertaking, could be a pivotal step towards fashioning a more just, equitable and compassionate international order. Reforming the Fund could strengthen the commitments of national governments to meeting basic human needs, protecting human rights, and increasing self-reliance.

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The IMF
Roughest Bank in Town

by Ron Chernow

FOR THE PAST TWO YEARS, Peru—a country hitherto spared the Latin American dialectic of left-wing terror and military reprisals—has been jarred by riots, sabotage, looting, arson. Power stations have been blown up, factories wrecked, railroad tracks uprooted. To squash two general strikes—the first in Peru since 1919—the military has resorted to martial law, rounded up hundreds of dissenters, and killed at least two dozen demonstrators. In June the military junta briefly postponed elections for a Constitutional Assembly, a blow to the restoration of civilian rule. The turmoil hasn't been the mischief of radical cadres. Rather it has been a spontaneous protest against the end to government food and fuel subsidies ordered by those most sober of all economists—the highly respected technicians of the International Monetary Fund.

Increasingly, the IMF has found itself splashed across front-page headlines as its programs have caused angry, and even bloody, protests. Some analysts date Sadat's autocratic turn to a 1977 IMF plan that slashed Egyptian food subsidies and unleashed riots that left hundreds dead. In Zaire, the IMF has amassed such power that a Fund technician is now installed in the Central Bank to oversee economic activity. In Jamaica, the Fund has become *the* hot political issue, with pro- and anti-Fund signs now placarding the island. Even in England, the seemingly omnipotent Fund got the Callaghan government to espouse such deflationary policies that a Labor government found itself saddled with a Tory program of public-service cutbacks. Mindful of this clout, few would quibble with Cheryl Payer's appraisal in her anti-Fund polemic, *The Debt Trap*: "The International Monetary Fund is the most powerful supranational government in the world today. The resources it controls and its power to interfere in the internal affairs of borrowing nations give it the authority of which United Nations advocates can only dream."

This may seem like an extreme indictment of a 135-member organization that performs a short-term technical function: monitoring exchange rates and aiding countries in balance-of-payments crises (its sister institution, the World Bank, is responsible for long-term development, and both are technically part of the United Nations). But the Fund has recently gained immense power over many needy countries.

Originally, the IMF was a response to the anarchy of global markets between the world wars. Struggling with high unemployment, many countries tried to cheapen their wares through competitive devaluations. These "beggar-thy-neighbor" policies set the stage for the Great Depression. In 1944 the Bretton Woods conference created the IMF as a multilateral umpire to supervise a system of fixed exchange rates; the organization was also empowered to make small loans to tide countries over the temporary payments deficits that are an inescapable part of free trade.

But this modest picture is a thing of the past. The upheavals of the Seventies—the OPEC price boost, the commodity boom, stagflation in the industrial countries—have produced balance-of-payments nightmares in many countries. While a few nations—the OPEC

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the United Nations itself—means not only that right-wing nations may get a break over left-wing, but that the economic ideology of the great powers will prevail. Last May, H. Johannes Witteveen, former IMF managing director, gave a speech in London setting forth the monetarist underpinnings of the Fund. Witteveen endorsed the classic conservative argument that inflation comes, not from oil or wheat cartels, but from the prodigality of people: Consistent with this ancient wisdom, he conceded that the Fund prefers to damp down demand—rather tha clamp on price controls—to solve inflation. Repeatedly, Witteveen credited the pricing system—the conservative's free-market solution of choice—as the Fund's favorite economic lever.

"Their clear predilection is toward free markets and laissez faire," says Howard Wachtel, an economics professor at American University. "When you look at the IMF agreements, there's a standard format, almost a prefabricated plan—devalue the currency, eliminate subsidies for food and other necessities, free the markets, and make the investment climate better for foreign corporations."

Even a Fund defender like Robert Solomon, an economist at the Brookings Institution, wonders how perfectly IMF programs have been tailored to individual economies. "I have the feeling that there is a tendency in the Fund to apply classical, well-accepted policies, when perhaps something more innovative, imaginative, and less traditional is needed."

The IMF itself makes little attempt to counter these criticisms. The Fund is supercryptic and tight-lipped about how it works, and studiously colorless in its public image. When the Fund sends a team of economists to Lima or Islamabad, it spends weeks quietly poring over the country's books in a sweeping economic review. These missions are rarely photographed and even carry in tow a private secretary to insure confidentiality. After the Fund negotiates a loan program, it issues a terse communiqué of several paragraphs—that's it.

But the IMF has plenty of defenders, many of whom spy a certain hypocrisy behind charges that the Fund "imposes" terms. They contend that many governments secretly approve of Fund programs which they know will prove politically unpopular. Then they call in the Fund to do the dirty work and serve as the lightning rod for criticism that would otherwise be directed at them.

"It really is pretty unlikely that the IMF is going to impose conditions that some significant part of the government isn't already in favor of," says Solomon. "It's not a *deus ex machina* that comes from outside and tells them what to do."

But the Fund continues to be criticized by human-rights advocates, who feel that countries must resort to repression to enforce tough austerity programs. They backed a partially successful human-rights amendment that Rep. Thomas Harkins (D-Iowa) and Senator James Abourezk (D-South Dakota) tried to tack on to an authorization bill for a new $10 billion IMF facility. The move succeeded in requiring the U.S. executive director to the Fund to draft an annual report to Congress, appraising the impact of certain IMF loans on food supply, housing, public services, and productive jobs in the recipient countries. But sponsors couldn't muster support for a clause that would have obligated the U.S. director to the Fund to oppose loans to countries that violate basic human rights. Third World Fund members seem sympathetic to the spirit of the amendment. But they would prefer to see fewer—rather than more—conditions imposed on IMF loans, as a means of achieving the same results. As a result, the IMF will probably remain the only international agency in which the U.S. delegation is not bound by some kind of human-rights language.

Beyond human rights, the deeper and more critical dilemma for the Fund may be the clash between short-term stabilization programs and the long-term development of Third World economies. When the IMF demands budget cuts to curb inflation, the member country can't shut hospitals or schools or fire hordes of civil servants; the most expendable item is often the development program. Some Third World diplomats are fatalistic about this conflict between immediate stability and long-term development. G. Arthur Brown, former head of the Jamaican Central Bank and now deputy administrator for the U.N. Development Program, likens the situation of a Peru or Egypt to that of a man with a broken leg who is suddenly crushed in a car accident and is bleeding to death. "You have to deal with the bleeding even if it prejudices the leg," says Brown.

But other Third World strategists argue that their countries cannot afford to stagnate while they iron out their foreign-exchange problems. Indeed, they say, underdevelopment is really the root cause of their deficits. They feel that much more sizable IMF loans, with fewer strings attached, would enable them to satisfy foreign creditors without crippling a development program. Repeatedly they stress that the surplus countries are equally responsible for maintaining equilibrium in world trade.

In the final analysis, the Fund's critics believe that it must cease to be a crusty conservative institution that recruits staff only from banks and monetarist economics faculties. "These people should have a background in development economics, politics, and sociology," says Syria's Al-Atrash. "There should also be people who occupied senior positions in their governments and whose economic theory is refined by practical experience."

AT THE SAME time, the developing countries feel there must be more flexibility in the Fund's noble free-trade philosophy if it is to work as well for poor countries as it has in the past for the rich. They argue that their infant industries need protection in a world rife with sophisticated, aggressive Western businessmen. Likewise, most of them would prefer taxing luxury imports to burdening the poor people with higher food and fuel prices as a means of bringing down import bills.

Any discussion with developing-country diplomats inevitably winds up with the preventive medicine of the "new international economic order," a package of proposals being pushed by the Third World that includes commodity agreements to stabilize raw-material prices, increased financial and technical aid, and a renegotiation of the debt burden that now traps so many poor countries. A country like Peru, they point out, has been penalized as much by the sudden slump in world sugar, iron, and copper prices as by its own costly errors. It was perhaps inevitable that OPEC price rises and stagflation in the West would, under present circumstances, deal it the *coup de grâce*. If free trade is to flourish, conclude IMF critics, then the rules of the games must be slightly altered so that everyone competes on a more equal footing. Says the United Nations' Arthur Brown: "If the people who export copper and bananas and sugar had more stable earnings and higher unit prices, clearly they'd be better able to withstand these international vicissitudes that occur from time to time."

Till that time, many poor countries will continue to bleed while the IMF supplies its deep, painful surgery.

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bloc, Germany, and Japan—are storing up whopping surpluses, the planet is also strewn with casualty countries, losers in the free-trade game. Developing countries are especially prone to such deficits, since they must import capital goods to develop. When such a country runs out of foreign exchange, it must turn to the IMF, as the lender of last resort, for cash to purchase crucial imports. Suddenly, the IMF is swamped with customers, and desperate ones at that, giving it far more power than the architects of Bretton Woods could have imagined. But the IMF's authority doesn't end there: It has emerged as the Standard & Poor's of global finance. Private bankers commonly balk on all further loans till a country has trimmed its sails to IMF specifications. This "linkage" has magnified the already awesome power of the IMF's $40 billion in currency reserves, and made it the "enforcer" of the Western capital market.

THIS SUDDEN access to power has sparked accusations that the IMF functions as a repressive tool of the industrial nations that dominate it. "A hundred years ago imperialism meant working with guns and arms and gunpowder," says Eduardo Pesqueira, a recently retired executive director of the World Bank who represented Mexico and six other Latin nations. "In our day, it is much more subtle and fine. It works through international organizations. It is the newest and finest expression of imperialism."

Clearly the world needs such a monetary paladin. But the source of contention is the conditions that the IMF claps onto loans—conditions, say Third World diplomats, that have become increasingly astringent and restrictive. Though the Fund claims that it only specifies broad fiscal and monetary targets—for instance, next year's inflation rate—developing countries claim that the Fund has gotten into the habit of spelling out exactly how such targets should be met—by devaluing the currency, cutting back public works, etc.

"The measures that many countries have to take are nearly tantamount to surrendering their sovereignty in the economic field," says Muhammad Al-Atrash, another recently departed IMF executive director from Syria (and 15 other Arab nations). "The Fund should *not* adopt the position of an overall economic reformer."

Another Third World director, requesting anonymity, grumbled about the "delusions of grandeur" of the staff in dictating tough terms to sovereign states. "These chaps should not go about like children dressed in policemen's uniforms—bang, bang, bang," said the director, as if firing a cap gun. "This is not a rich man's club." The terms which the IMF staff sets as conditions for its short-term loans invariably embody the conservative goal of combating inflation by reducing government spending—and, consequently, reducing welfare-state measures. Not surprisingly, IMF programs have proven least palatable to the poor and have provoked popular revolts. This has raised the question of whether democratic regimes, sensitive to human rights, can possibly satisfy the Fund without resorting to muscle to squash wide-scale protests.

Here Peru's example is particularly instructive. American bankers so fully shared the nation's sanguine view of an export-rich future that they pumped $1 billion into its economy. But a syndrome was at work that would pauperize Peru and make it, according to the *Wall Street Journal*, "the biggest problem for U.S. bankers" of all the developing countries: World grain prices rose in tandem with oil prices; the cost of Western goods outpaced the price of Third World commodities; the market slumped for Peru's sugar, copper, and iron exports; public-works boondogglers strapped the country with debt; the anchovies disappeared from the Peruvian coast; and the Peruvian generals' gluttonous appetite for arms sealed the country's fate. As the debt mounted to $8 billion, and Peru threatened to become the first Third World nation to default on its loans, the World Bank and other Western-dominated credit sources cold-shouldered a country that had nationalized foreign oil and copper companies. The bankers panicked.

"The problem in Peru was that the foreign banks got into the position of having to deal with the government as if they were the IMF," says Robert V. Roosa, Undersecretary of the Treasury for International Monetary Affairs in the Kennedy administration. "It proved necessary to push the bank consortium aside and get a more accredited body of international civil servants to take over that role in Peru."

Apparently the bankers had gotten so jittery about Peru's future, and the increasingly hostile attitude that was characterizing the banks as "imperialists," that the Fund was viewed as just the neutral body to straighten things out. But it was IMF's program of monetary and spending restraints that ultimately triggered the violent reaction.

Since many of the IMF's major customers are developing countries like Peru, it may seem curious that these nations, all members of the Fund, fail to work out a less painful policy. One reason is that the IMF is, in fact, a "rich man's club."

While the group has 136 member countries, the U.S. casts a weighted vote of about 20 percent; the major 10 industrial powers jointly control a majority of votes. The rationale for this is that the larger countries contribute the bulk of currency reserves and should be entitled to commensurate power. A Fund spokesman stresses that countries join voluntarily: "The IMF is a private club and the members must accept its rules." But critics retort that membership is really compulsory in the contemporary world; otherwise a country will be frozen out of the World Bank, other international development agencies, and the private credit markets.

The Fund is supercryptic and tight-lipped: Its missions are rarely photographed and even carry in tow a private secretary to insure confidentiality.

The upshot of this lopsided power structure is that developing countries often feel that they operate under a double whammy in the Fund. While the Fund staff lays down especially strict conditions for them, it eases off on the special friends of the big powers.

"In developing countries, the IMF will say, 'Okay, we don't want to see expenses for armaments,'" says Samuel Nana-Sinkam, an IMF director from Cameroon. "But if they go to Europe and the country says, 'But these armaments are for strategic purposes,' the Fund will just close its eyes."

Conversely, most IMF and World Bank directors privately concede that the U.S. and Western European countries manage to obtain special favors for their poorer friends in the Fund. Jim Morrell, head of the Washington-based Center for International Policy, concluded, in a study of confidential IMF Executive Board minutes, that U.S. allies like Argentina and South Africa received far softer terms from the Fund than left-leaning governments like Jamaica or Peru.

The IMF's domination by the great industrial powers—in glaring contrast to

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-Sun., Dec. 9, 1979 Los Angeles Times

Malnutrition Rises as Peru Economy Sags

70% Inflation Rate Puts Proper Diet Out of Reach for Many

LIMA, Peru (UPI)—Despite heartening external economic signs, Peruvian inflation continues to climb and is likely to reach 70% by the end of this year, cutting deeply into real incomes and making malnutrition an unwelcome guest in hundreds of thousands of homes.

The restructuring of a $10 billion foreign debt, a healthy increase in exports and a slight upturn in industrial growth in the first half of the year have given Peru's economic managers and their International Monetary Fund watchdogs guarded optimism.

But the real income of Peruvian workers fell to a little more than half their original purchasing power between 1973 and 1978, according to official statistics.

"Each day the situation grows worse," said Sister Rosa Ballon Vera, secretary general of Caritas-Lima, a Roman Catholic relief organization that distributes American food aid.

"The economic crisis has increased the severity of the problem tremendously," she said. "There's been a great devaluation of our currency, we owe a great amount of money to the international banks. This has caused an increase in unemployment because production is down and people get fired from their jobs.

"The salary increases have not been equal to costs of living and the majority of the people do not even have regular salaries," Sister Vera continued. "The international situation may be improving, but inside the country, I don't see any differences. The inflation just goes on and on."

She estimated that 60% of the Lima area's 4.5 million people suffer from some form of malnutrition because of minimal purchasing power.

Increasing government spending fueled inflation in the early 1970s, and it later grew worse with the removal of subsidies on essential foodstuffs. Meanwhile, declining or negative economic growth rates pushed the 1978 official unemployment figure to 8% and increased the underemployment rate—the number of people without regular jobs and a fixed income—to 53.8%.

A May, 1979, U.S. Agency for International Development study estimated that between 420,000 and 1.14 million people in metropolitan Lima suffered from severe nutritional inadequacy. To help meet the crisis, AID granted Peru $100 million in 1979.

Caritas-Lima is attempting to keep people partially fed through special "Work for Food" programs, mainly in the impoverished "Barriada" slums known as *pueblos jovenes*, (young towns).

"We do not want to be paternal, because the people would cross their arms and go on having more babies," Sister Rosa said. "So we organize the people to work in community programs in exchange for the food."

Every month Caritas programs distribute food supplies to feed 74,887 children and 8,658 adults in 330 programs.

"These are supposed to be complementary food programs but, unfortunately, it is the only food any of these people receive," she said. "The original concept was that if these people receive this food, they will have a little money to buy some meat or milk, but the large families don't have any money and then complicate the problem by having more children."

Sister Rosa said the Caritas food gives people something to eat, but she lamented the poor protein levels and said she badly needs to start distributing milk. According to government figures, Peru's per capita annual milk consumption fell from 149.6 pounds to 114 pounds from 1970 to 1978.

"There is practically no milk in these peoples' diets, and I'd say only about 15% occasionally eat some fruit or vegetables," said Severo Gutierrez Castaneda, a zone supervisor for an emergency feeding program run by the Seventh-Day Adventist World Service in Lima.

"The idea when we started this program was it would run for one year with the hope the Peruvian economic programs would improve," Gutierrez said. "But the country is still in a crisis so we have had to extend it for another year. We feed about 10% of the people here, and, if we had more food, we could easily start five or six more programs."

Peruvian Finance Minister Javier Silva Ruete, the architect of the government's financial recovery program and the man who has instituted the IMF's tough austerity programs, recently admitted some hungry people have begun eating chicken feed in order to survive.

"But what is more serious," Silva Ruete said, "is that there are people who do not even have that (chicken feed) food regularly."

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THE NEW YORK TIMES, FRIDAY, AUGUST 24, 1979

Peru's Babies Are Dying

By José Carrizo

Maria Gomez came with her baby in her arms to the house of the parish in the Peruvian city where I serve the people. She knew the baby was dying. So did I. It was the third emergency baptism I had to perform that day.

In that city, the number of emergency baptisms has risen dramatically this year. Nationally, the number of babies who die before they learn to walk has jumped some 30 percent, to 109 per 1,000. That translates into an additional 13,000 infant deaths a year. No one seems to notice. Children have a way of dying quietly. It's a massacre of the innocents.

The press does not record such deaths. Local and foreign journalists file stories on the new Constitution and the proposed transition from military to civilian rule. The news media paint a picture of a people involved in making a reasonably peaceful transition from dictatorship to democracy and imply that economic progress is waiting around the corner.

Nothing could be further from the truth.

The central issue is economic, not political. Unless the economic noose strangling the country is loosened, the political transition will not matter.

Skyrocketing oil prices, failing fishmeal production and Government mismanagement combined to bring Peru to the brink of bankruptcy in 1976. That year the International Monetary Fund stepped in to rescue the nation, at a price that grows steeper with each passing month. The I.M.F. formula to qualify for loans and credit is simple: Cut Government spending, including subsidies for basic foods if necessary. Devaluate the currency to make exports more attractive and to discourage imports. Hold down wages to avoid inflation. But the social costs of this program, which the military Government implements and enforces, have been awful.

In the last four years, the worker's realy buying power has been cut in half. Only 45 percent of the 5.2 million in the work force have stable work. The price of bread has jumped 1,000 percent. Per-capita calorie and protein intake are but two-thirds of those listed by the Food and Agriculture Organization as the vital minimum. Condensed milk consumption in Lima plummeted from 560,000 kilos in December 1978 to 280,000 in March 1979. The relation between such statistics and the rising infant mortality rate is obvious.

The dread results are not lost on some officials. In a recent intgerview, Manuel Moreyra, president of the Central Reserve Bank, acknowledged that "the social cost of this policy is dramatic. It represents some 500,000 children dead, and implies an indisputable reality: Peruvians are submitted to a starvation diet." However, two weeks after the interview, prices were again raised 30 percent. Wage increase were also decreed, but not proportionately..

As a result of all this suffering, the population supports current labor unrest.

There have been three national work stoppages in the last two years. The only other such show of force in Peruvian history was one work stoppage 50 years ago. Besides these, there have been strokes by the miners, bank employees and Government workers — too numerous to count.

Some 100,000 teachers struck in June, their second such strike in two years. A policeman with fifth-grade primary-school education and six months' training starts with a salary 50 percent higher than an experienced teacher's. Besides salary demands, the teachers stressed that they were tired of trying to teach students who are on the border of starvation. For this reason the strike lasted. The people, without any voice because of Government repression and fear of losing their work, rallied around the strike and made it their own.

Peruvians are not chattering excitedly about the prospect of civilian rule. They are demanding a change in economic policy. Whether that policy is implemented by a civilian or military government is secondary. The people are crying out for work and just wages. Jobs are their priority, not CARE packages.

They are tired of seeing children die in this, the international year of the child.

José Carrizo is the pen name of a Roman Catholic priest.

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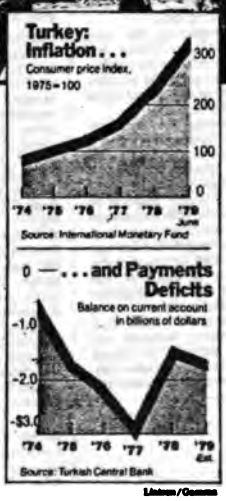
I.M.F. Pressure Embitters Turks



Linton/Gamma

A Turkish armored car patrolling the streets of Istanbul.

Fund Reported To Ask Tighter Austerity Plan

Special to The New York Times

ANKARA, Turkey, Dec. 14 — Reports that the International Monetary Fund is demanding new austerity measures from Turkey are bringing sharp protests from embittered Turks. "If we tighten our belts any more, life will become unbearable," said a retired engineer here. Like civil servants and military personnel, he has suffered a real loss of income with the inflation rate now at 100 percent.

An I.M.F. team has come here to meet with the new Prime Minister, Suleyman Demirel, and his Government to see if they are willing to go along with the strict stabilization program agreed on last July by former Prime Minister Bulent Ecevit.

Mr. Demirel, who is known for big spending policies and his wish for early general elections in the spring, is expected to try to avoid drastic action. But aides say he will go along with the I.M.F. program in the end "because there's no alternative" to obtaining badly needed foreign credit.

The leader of the pro-Islamic National Salvation Party, Necmettin Erbakan, whose support is crucial to the Demirel Government, warned against following the I.M.F. prescription, which, he said, "has brought nothing but pain to the nation." Mr. Erbakan accused the I.M.F. of "destroying" Turkey over the past two years, with its

I.M.F. Pressure Is Embittering Turks

insistence on devaluation, and stressed that it had been one of the main factors in the downfall of the Ecevit Government.

After much hesitation, Mr. Ecevit's left-of-center Government took the unpopular measures required under the I.M.F. program, a sharp 78 percent devaluation of the Turkish lira and steep price rises on steel, gasoline and other products. These reforms paved the way for a $350 million standby credit from the I.M.F. and a Western emergency package of another $1.45 billion aid. But the money has been slow in coming and the positive effects of the agreement are not visible.

Bitter Turks, seriously affected by inflation and shortages and worried about the breakdown in law and order, showed their disillusionment in the Oct. 14 midterm elections. Mr. Demirel's conservative Justice Party, the main opposition, won a sweeping victory, forcing Mr. Ecevit to resign.

Now Mr. Demirel is faced with the same problems, which seem only to get worse. Political violence, which has taken 2,400 lives in the past two years, is steadily increasing; an average of 10 persons are killed every day.

Today, it was reported that four Americans — a military officer and three civilians — were killed by unidentified assailants, bringing the number of Americans killed in the recent wave of violence in Turkey to seven.

As for the economy, Turkey now faces a $14 billion foreign debt and a deficit of $1.5 billion to $2 billion in its current account. Foreign currency problems are a result primarily of the rise in oil prices. Turkey imports 85 percent of its oil needs, which consume all of its export earnings and have therefore led to shortages of other import items from coffee to spare parts and raw materials. In addition, the country is burdened with an unemployment rate of about 20 percent.

The West is concerned about Turkey's plight, essentially because this strategic country controls the Black Sea route into the Mediterranean and, since the Iranian revolution, is now the West's only listening post on the Soviet border.

Mr. Demirel came to power with the pledge to end terrorism, shortages and inflation, but stressed it would take time. For the time being, there's a mood of expectancy in the country, a hope that Mr. Demirel, an engineer by profession, will find solutions.

He has declared the fight against terrorism as his top priority and has overhauled the police. Some of the worst shortages already have been eliminated. A shipment of 1.3 million tons of oil has now been distributed, ending gasoline lines. Mr. Demirel also has freed the price of margarine and cooking oils, which immediately reappeared on the market with a 100 percent increase in price.

"It's better to pay more for necessities than not to have them at all," an Ankara housewife said, reflecting general opinion.

The business community in Istanbul also looks favorably on the Demirel Government, not so much for anything it has done but for the people who have been put into key positions, including many from the private sector.

Rise in Salaries Pledged

So far, Mr. Demirel has taken no special steps to hold down inflation. In fact, he has pledged to raise the coefficient for civil servants' and pensioners' salaries, increase birth allowances, overtime payments, civil servants' travel allowances and the food allowances of military personnel and provide every family with color television.

In response, a popular cartoonist showed a family sitting naked in a room without furniture, happily watching TV.

Western economists fear that Mr. Demirel may resort to his policies of the mid-1970's — rapid development based on short-term, high-interest loans — held responsible for many of the country's problems today.

The I.M.F. insists on further devaluation of the Turkish lira, tax reforms, and new price increases for oil, sugar and fertilizer as the condition for continued Western aid. What the I.M.F. wants, according to reliable sources, is the establishment of a flexible rate for the lira to encourage exports. It has been suggested that the lira rate be raised this month from 47.10 to 52 to the dollar and from 35 to the dollar to 45 for petroleum and fertilizer imports and agricultural exports.

The I.M.F.'s program could mean in the short term a drop in real income by half, according to independent economists. The question the authorities and Western diplomats are asking is: Will the Turks take it?

The 60-year-old retired agricultural engineer, who asked not to be identified, refused any more austerity. He noted that his family made its own coffee from soybeans, had cut down on electricity and gas, ate meat once a week and had given up any idea of getting a car.

'Can't Afford Real Meat'

Irfan Borekci, a 42-year-old shopkeeper with a wife and two daughters, earns an average of 7,500 lira, or about $160, a month and has difficulty making ends meet as it is. "We eat sheep's head, fish and minced meat but can't afford real meat anymore," he complained. He said he has bought only one new suit since his wedding 19 years ago.

One million Turks earn a net salary of 5,000 lira, a little more than $100, a month and have to spend half of that on rent. The balance is not enough to live on, according to economic reports. Sociologists note that in the poorer quarters around Istanbul and Ankara, children are yellow from undernourishment.

The I.M.F.'s current talks with the Government have been held in secret, apparently to avoid public debate. Even so, there have been protests against continuing the relationship.

The State Planning Organization has questioned Turkey's relations with the I.M.F. In an official document reproduced by the independent daily Milliyet, the Government department warned of "the grave economic and social drawbacks" of ties with the I.M.F., which it said would "radically change Turkey's development strategy."

THE NEW YORK TIMES,

DECEMBER 15, 1979

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Christian Science Monitor - 10/18/79

From the media

The hazards of aid from the IMF

Khartoum, capital of the Sudan, has recently been the scene of intermittent rioting and demonstrations following drastic increases in the prices of some basic commodities, including gasoline, flour, and sugar. Workers on the crucial railroad system have gone on strike and, until recently, farmers were refusing to plant next season's cotton crop, the main source of foreign exchange. The cause of these disturbances seems very similar to that of the 1977 riots that broke out in Egypt in protest at sudden food price increases. Both countries were imposing measures approved by the International Monetary Fund.

Egypt has more severe problems than Sudan. But like Sudan, Egypt was having great difficulties with foreign debt.

Egypt's relationship with the International Monetary Fund follows a pattern fairly familiar among impoverished developing countries. In 1976, the IMF imposed borrowing conditions that were considered unnecessarily harsh and included the reduction of subsidies. The riots in January, 1977, were the result.

A new relationship between Egypt and the IMF was then worked out. Egypt was to receive the equivalent of $750 million over three years. It got an initial portion of $90 million on the signing of the agreement in August, 1978, but has not received others subsequently because it has failed to keep to the agreement. For the moment, the IMF has virtually abandoned one requirement – the reduction of direct and indirect subsidies, which have coincided with the budgetary deficit.

The experiences of Egypt, and now Sudan, show there are political limits to a program of economic orthodoxy supported by the IMF. In Sudan's case it may be questioned whether all the economic targets on which the IMF has insisted are even attainable.

Neither the interests of borrowers nor the IMF are likely to be served by the government of a recipient state being brought down for doing what has been suggested by the IMF. But there remains the problem of who should be the judge of what is politically as well as economically viable. – Financial Times World Business Weekly

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BUSINESS INTERNATIONAL

The Brandt commission's proposals for survival

"We want to emphasise our belief that the two decades ahead of us may be fateful for mankind": thus Mr Willy Brandt, on behalf of his 20 fellow signatories to a report called "North-South: a programme for survival". It will be presented to the UN secretary general in February, and published in March. *The Economist* has obtained a copy.

The Brandt commission was set up, at the instigation of (among others) the World Bank, in 1977. Its members come from the rich north, the oil producers and the poor south; most of them are politicians who have held office or still do. They have consulted frequently with governments, and think their recommendations are politically practical.

The report, bashed into final shape by an initially improbable team of Mr Edward Heath and Commonwealth secretary general Mr Shridath Ramphal, recommends an emergency programme, and then longer-term reforms. The emergency programme has four main planks:

- A large transfer of resources to the less developed countries (ldcs). The means proposed are, first, increasing official aid by $8 billion (in 1980 prices) annually; it was $21.4 billion in 1978. The aim is to reach 0.7% of the rich countries' gnp by 1985, and 1% by 2000. That 0.7% was originally a target set for 1980—and accepted by virtually all rich countries, which then fell miles short of it. Second, doubling the World Bank's lending, by changing its gearing ratio (borrowing to capital base) from the present 1:1 to 2:1. Third, using remaining IMF gold stocks as collateral to raise more money to lend to middle-income ldcs; and periodically selling some gold to provide an interest subsidy for the poorest ldcs. The commission reckons all this would boost the net flow to ldcs by $50 billion-60 billion annually (in 1980 prices) by 1985.
- An international energy strategy. This would impose obligations on producers (no "arbitrary" reduction in supplies if they can possibly avoid it) and on consumers (to accept tougher conservation goals than those agreed at the 1979 Tokyo summit). The authors believe this would achieve "more predictable and gradual price increases in real terms". The commission feels that ideas like automatic indexation of oil prices, payment in a basket of currencies, and real-value guarantees for oil producers' financial assets should also be considered. More research is needed into alternative energy sources.
- A global food programme. This would involve putting money into ldcs' agriculture (in 58 out of 106 ldcs, population grew faster than food production in 1970-78); more food aid; and larger food stocks, which (the authors think) would improve food security world wide.
- Major reforms in the international economic system. The commission wants a start made immediately, but its proposals are essentially long-term.

Mutual, universal, automatic

Three themes run through the report. The first is that all countries have stronger mutual interests than they recognise—in providing growing markets for each others' products, in security of supplies, in a more stable international monetary system. And all would benefit if all would agree to spend less on armaments.

The other two themes are criticisms of present North-South links. First, they are run by outdated institutions and arrangements. Virtually no communist countries are represented in the International Monetary Fund or the World Bank (nor, for that matter, on the Brandt commission, which involved them in its discussions whenever possible). Instead the communist countries have sat on the sidelines, their warnings about "capitalist plots" serving as a pretext for not getting involved in ldc development. Most of the ldcs themselves were still colonies when the IMF and World Bank were set up. Since independence, they have never achieved the standing in either which their numbers or importance as clients deserve.

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The second Brandt criticism is that there are no automatic sources of development finance. Poor countries in deficit have had to rely on loans from unreliable rich countries' governments and (increasingly) banks, which have so far plugged some ldcs' deficits, but will never plug them all.

These themes lead to the commission's long-term proposals—over 60 of them, which can be roughly grouped into four:

- World Keynesianism (though the commission doesn't call it that), so that the ldcs' needs can be turned into effective demand for the rich countries' underemployed factories. Increased aid would help to create some of this effective demand; so would official guarantees for more commercial lending. The commission also revives one longstanding proposal—to link increases in official liquidity to development aid. The report wants Special Drawing Rights to replace national currencies as official reserves; the ldcs would get the extra SDRs and spend them into circulation.
- Changes in trading arrangements, particularly to try to bring greater stability to raw material prices (through more commodity agreements and bigger compensation when real commodity earnings fall). Trade barriers should come down, especially those which stop ldcs from processing their own commodities before exporting them. The kind of taxation the commission thinks feasible includes small levies on eg, world trade, freight transport, air travel, ocean fishing and mining, and arms spending. Any money attributable to particular countries could be counted as part of their aid; the ldcs themselves would have to contribute, but on a sliding scale.
- Institutional reform, partly so as to include the communist countries and also to develop new types of lending. The commission is critical of some aspects of the IMF's conditional lending; of the World Bank's continued centralisation in Washington; and of both the IMF and World Bank for not having enough ldc nationals on their staff or ldc votes on their boards. It wants the IMF to lend for longer periods, and the World Bank to devolve some of its work to the regional banks. The UN and its agencies should avoid duplication, and strive for greater efficiency. International trade ought to be overseen by a body formed by merging Unctad and Gatt.

The report also proposes, "for consideration", a new institution—the World Development Fund. It would have universal membership, and lenders and borrowers would share decisions less unequally than they do in either the World Bank or the IMF. The World Development Fund would concentrate on programme lending—ie, money which is not tied to particular projects, as World Bank loans are. Universal taxes would flow into its coffers.

Once the report is published, what will become of it? Mr Brandt would like an early world summit, of perhaps 25 leaders from both rich and poor countries, to consider the report and start putting some of its proposals into action. Ten years ago, he and several members of his commission would have been at such a summit. They can now agree. What about their successors?

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Chairman NEAL. Thank you, Reverend Chauncey.
Dr. Cline?

STATEMENT OF DR. WILLIAM R. CLINE, SENIOR FELLOW, THE BROOKINGS INSTITUTION

Dr. CLINE. Thank you, Mr. Chairman. It is a pleasure and an honor for me to be here today to testify on the subject of lending by the International Monetary Fund. The basic legislation being considered is, of course, the proposal to raise the quota of the IMF, and I would first like to address a few comments to that issue. Then I will concentrate most of my comments on the issue of conditionality in the IMF and its implication for concerns such as basic human needs.

I think that most people would agree that there has been no better time for an increase in the IMF quota than the present. The proposed increase would raise the quota from $39 billion Special Drawing Rights to $58 billion, and even this increase would leave the IMF resources at less than half their size relative to world trade than they were 20 years ago.

That in itself would be enough to warrant the quota increase. In addition to that, we have the problem of the huge OPEC surplus caused by the doubling of oil prices in 1979. The most recent estimates are that the OECD countries will have a current account deficit on the order of $50 billion in 1980 and that the non-oil-developing countries will have a current account deficit on the order of $70 billion. And this is compared with a combined current account deficit of only $27 billion in 1978.

So we are looking at about a $100 billion swing in the current account deficits in these two groups of countries, and in the face of this deficit, the increase in the quotas in the IMF are indispensable. I think that even the critics of the Fund and its conditionality are quick to point out that the Fund needs more resources. In fact, one of the criticisms that they make is that countries often wait too long to go to the Fund until their situation reaches a crisis stage, precisely because they think the Fund does not have enough resources to make the effort worth the price.

So it seems to me that there is a widespread consensus among supporters and critics of the IMF that the institution needs more money, and that is the principal legislative issue most directly concerned here, and I firmly support the quota increase for the Fund for that reason.

Let me turn then to the second issue—that of the Fund's conditionality. There are essentially two lines of critique on Fund conditionality. The first is a general critique that the conditionality is too severe.

And the second line of critique—often from different groups—is that the Fund should pay more attention to income distribution and to the plight of the poor. That implies, in fact, making conditionality more strict in the sense that it would be adding on an additional performance condition—namely, that the particular program would have to be channeled in such a way that it would not be detrimental to the poor.

My view on both of their critiques in summary is that neither one of them provides the basis for a major change in the IMF

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conditionality approach. With respect to the general use of conditionality, the point is that the conditions are an important part of obtaining balance-of-payments correction and that a loosening of the conditions would probably erode the possibility of balance-of-payments adjustment.

And as I will elaborate in my further comments, such a loosening would also jeopardize the relationship whereby the private banks use the IMF's stamp of approval as the key to their providing funds to countries that are in difficult situations.

With respect to the second line of critique, although advancement of basic human needs is a laudable goal, and some of my own writings in the past have concentrated on the issue of income distribution, it does seem to me that it is going to be counterproductive—or at least not very effective—to put in legislation which would require the Executive Director to vote against an IMF standby package because it did not meet some prescribed conditions of equity to the poor. Let me set forth my reasons why.

First, on the question of the role of conditionality, the IMF loans money at interest rates that are below the market rates—approximately 4 to 6 percent interest—where countries are typically borrowing at 13, 14 percent. So there is a benefit provided by the international community to the borrowing countries.

Moreover, the Fund has a mandate in its charter to make sure that these funds will be used in a way that they will be repaid. The Fund has revolving funds. This is not a long-term aid agency. These are not grants. Conditionality, then, is part and parcel of the Fund because it is the procedural basis on which the Fund can legitimately expect a repayment of the funds that it does lend.

We all know the typical kinds of terms of Fund conditionality packages—limits on domestic credit, money supply expansion, limits on government deficit, targets for reducing the amount of external borrowing. These kinds of objectives play a direct role in turning the country's economy around, but they also play a vital role as stamp of approval for the international banking community.

Typically, the resources that a country needs go beyond what the IMF can provide, especially through its normal quota of resources, and it is essential that the private banks supplement the Fund's resources in order to help a country gain its balance-of-payments equilibrium.

At this point in time, the private banks still regard the IMF as a credible institution. When the IMF says that a particular country is making progress in turning its situation around, the banks believe it. I suggest that if we encumber the IMF's performance criteria with new requirements on the one hand and with an attitude which suggests that we undermine the severity or the rigor of those conditions on the other, the stamp of approval will be debased, and the banks will no longer find it credible when the IMF says that this country is making progress and it warrants additional lending. That result would choke off the more important source of resources, namely the private banking system.

So, for that reason, I think there can be little doubt that the credibility of IMF conditionality is an indispensible part of this entire mechanism. There has been a line of critique that after all

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the developing countries' problems now are caused by outside shocks, that there has been the oil price increase, commodity price increases, and so forth, and that for that reason we can dispense with conditionality at this point in time—it is not the fault of the country; it is the fault of the system.

I don't believe that conclusion holds up to analysis. It is true that external shocks in the mid-1970's caused a great deal of the problems in the developing countries. It is also true that some developing countries did better than others in responding to those shocks, and the reason they did was that they followed better internal policies.

A recent statistical study by Stanley Black at Vanderbilt University concludes that probably more of the balance-of-payments problems of developing countries in the 1970's were attributable to internal policies than to external shocks. So we do have to keep a balance between attention to outside shocks and to internal policies, and the conditionality concept is essential to maintain if the internal policies are going to be viable ones.

Let me turn from the general issue of conditionality to the specific issue of the impact of IMF conditions on the poor. I think perhaps the most important perception here is the following:

It is not clear to me that any change in legislation that we might make or changes in the articles of the Fund that we might make would be terribly operational in terms of changing how the Fund acts, how it designs its packages, because I think it would be very difficult to assert that the Fund's past practice has been purposely to choose stabilization packages that hurt the poor. The Fund does not sit back in Washington and analyze two different programs and say, "Here is a program that will hurt the poor; here is a program that will hurt the rich. We think you should choose the program that will hurt the poor. They will both work to cause adjustment."

That is not the situation that I see. What I see is the Fund working with the government, grasping often at straws for any viable program that will turn around the balance-of-payments crisis and putting together the best package that it can.

So I think that the Fund, in all good conscience, in virtually all past cases could have said when the Executive Director said, "Is this program going to hurt the poor", the Fund could have said, "No, this is not a program we have designed to hurt the poor. We believe that this program, especially over the time of 4 or 5 years, is the best we can do for the poor and for the country as a whole."

So it is not clear to me that there would be much operational change resulting from any amendment to require the Executive Director to vote against a program because at a superficial level it did not seem to meet equitable income distribution objectives.

I think the basic problem here is that we tend to look at the bad results that we see and to assume that there is a better alternative. Typically the kinds of accounts one gets in the press about the impact on the poor in cases such as Peru or Egypt do not really set forth a convincing alternative strategy, whereby there could have been a radically different result with a much better outcome for the poor in this period of time.

And once again, the crucial thing is to look at the medium- and long-term results. Policies which seem to sustain the situation of

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the poor over a brief period of time can easily be unsustainable and lead to greater hardships for the poor in the long run when the country comes up against the final crunch and must default on its debt and stop getting imports.

In this connection, I would like to refer briefly to a study that I have done on Peru in connection with the recent Brookings Institution Conference on Stabilization in Developing Countries. My analysis of Peru is somewhat at variance with the typical press reports and the analysis of some academics, although I would say it agrees almost completely with the analysis of most economists in and out of government in Peru, and that is the following:

The basic problem in Peru was not that the IMF came in with a heavy hand and caused suffering of the poor. The basic problem was that the Government did not act early enough to keep what might have been a manageable situation from deteriorating into a crisis situation. The Government already had serious balance-of-payments deficits in 1974 and 1975. The Government pursued a policy of massive military spending and imports. The Government was pursuing programs that discouraged exports, programs that discouraged investment in industry, programs that led to a poorly executed land reform.

And I must say the banks made the situation worse. The banks were lending a great deal of money to Peru. The banks, I think, have tended to think that their risk will be borne by the international community, that if their loans get into trouble, someone will bail them out. And so I think they have tended to lend more than they would if they were internalizing the total risk.

Well, Peru, then, did not act soon enough, and as a result, in 1978 when it did have to act, when it was on the brink of default, it had to take very extreme measures. Some of those measures which were politically the most inflammatory were not measures that hurt the poor, the really poor.

Item: The Government cut out subsidies for gasoline. Well, the people who have the cars to drive and consume gasoline are mainly middle income and upper middle income groups. Item: Wages went down. Well, the group that suffered the most from decline in wages was the white-collar workers. Wages for 1970 to 1978 went down by 36 percent in real terms for white-collar workers. They went down by 28 percent for blue-collar workers.

But I think we have to recall in a country like Peru, the salaried workers—even the blue collar workers—are in the middle or upper middle of the income distribution. The rural poor did not have the same kind of massive reduction in their income. I think it is accurate that the urban poor in the unorganized sectors have suffered considerably, and I think Father Burns has graphically depicted their plight. These people are not salaried labor, but they tend to have activities that are geared to the level of salaries in the city.

In summary, even in the case of Peru, the situation was not that the IMF came in and favored a program that hurt the poor. On the contrary, the situation had gotten so far out of hand that there was practically no alternative. And even given that, the results were not as bad for the really poor as the press accounts would typically have us believe.

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I think the fact that the alternatives are not really all that viable may be illustrated by Chile under Allende. In the last days of the Allende regime, there were unrealistic price controls. There were artificially high wages, and the economy was essentially going into a shambles. I think one of the big lessons of Chile under Allende was that even under a leftist regime desiring to help the poor, you have to have viable economic policies. And it seems to me that the perception of what those viable alternatives are is something that we have to introduce into this discussion in order that it take on a bit more realism.

Now, criteria on income distribution for IMF lending, in my view, are not a good idea. And I would cite two basic reasons.

The first is a technical reason. I think it is difficult on technical economic grounds to assess the income distributional consequences of a particular stabilization program and to compare them with the distributional consequences of another program.

Let me give an example. At a superficial level it might seem that allowing wages to go down is the last thing we would want to do if we were going to protect the poor. However, in a country where there is a fairly narrow group of urban workers who are salaried workers, they represent a certain privileged worker class, and a reduction in the real wage may, in fact, make it possible to spread employment to people who are not yet incorporated into the urban wage group—people in the countryside—as firms find it more attractive to hire workers rather than to use capital. The IMF has recently tried to do a study on the income distributional consequences of some of its programs, and one of the themes that emerges from the study is that it is very difficult to tell exactly what the distributional consequences have been.

So the point I am trying to make is this. I think it would be in large part a sham to assert in the case of a particular stabilization program that this program is going to have detrimental distributional consequences and that there is a clear alternative that will have favorable consequences for distributional purposes.

I could not agree more with Chairman Reuss that we need more information. We need more open minded thinking on this issue. For that reason, I would support language which would suggest more studies, which would suggest attention to income distributional considerations.

I don't think we have the answers. I don't think we have clearly analyzed alternatives to the more traditional approaches to stabilization. The difficulty in coming up with these kinds of alternatives has been illustrated in the efforts we have made at the recent Brookings Conference where we had many of the top academics in this field, and there were certainly no definitive breakthroughs in the assessment of this problem.

So this is the first reason, on technical grounds: it would be of doubtful operational content and something of a sham for the Executive Director to assert that a particular IMF program was detrimental to income distribution and could not be supported.

The second reason that I think it is doubtful to pursue this route is that it smacks of intervention. We have just changed the guidelines for conditionality in the IMF to reduce the degree of intervention in the internal choices of the countries. The developing coun-

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tries pushed very hard for this change in the wording which said that the guidelines or the conditionality would be oriented toward macroeconomic variables and that it would basically leave internal choices to the country.

Now this is in the context of a North-South confrontation on the issue of basic human needs. Basic human needs has become a charged word in the North-South context, and many in the South believe that the issue of basic needs is used as a pretext to not give aid. We see confrontation on this in the United Nations. We see it in UNCTAD, and I don't think it would be helpful to the IMF at this time, given its already complicated task of financing the OPEC-induced deficits—I don't think it would be helpful at this time to introduce it into the IMF forum this controversial issue which is already splitting the North and South in other forums.

I think that basic human needs criteria are appropriate for lending through IDA and even the World Bank. Those are long-term development programs. We are donors. We have a right to expect certain kinds of programs for our money, and they are clearly identifiable projects. If you have a project that gives millions of dollars to a few ranchers, that is a clearly inequitable loan. And it makes sense to say, "We are not going to support that kind of loan."

I don't think that the choices are crystal clear like that in the context of IMF conditionality. And so I think that what we will lose by politicizing the IMF even more by bringing the basic human needs controversy into the IMF will be more than what we will gain through inserting language which requires votes against programs that do not seen to meet, at first glance, the objective of income distributional equity.

In my prepared statement I have a few more observations about the state of economic theory, on the traditional IMF approach, essentially a monetarist approach as opposed to a structuralist approach. Perhaps that will come up in discussion. But I think I will stop at this point.

Thank you.

[Dr. Cline's prepared statement entitled "The Magnitude and Conditions of Lending by the International Monetary Fund" follows:]

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THE MAGNITUDE AND CONDITIONS OF LENDING BY THE INTERNATIONAL MONETARY FUND

WILLIAM R. CLINE*
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TESTIMONY BEFORE THE U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
SUBCOMMITTEE ON INTERNATIONAL TRADE, INVESTMENT AND MONETARY POLICY

FEBRUARY 6, 1980

It is an honor for me to testify before this committee on the proposed legislation to increase by 50 percent the U.S. quota in the International Monetary Fund. My remarks will concern the international economic circumstances in which this quota increase will take place, and the special subject of the performance conditions that the I.M.F. attaches to its lending.

The Need for More Resources

There could hardly be a more urgent time for an increase in the lending resources of the International Monetary Fund. The proposed increase in the Fund's total quotas from 39 billion SDR to 58 billion SDR will still leave the Fund with resources that, relative to the value of world trade, are less than half as large as they were twenty years ago. 1/ Even more important, the structure of world trade is once again entering into massive imbalance, as oil-importing nations face enormous trade deficits because of the doubling of oil prices during 1979. Recent estimates are

* The views expressed in this paper are those of the author and do not necessarily represent those of the trustees, the officers, or other staff members of the Brookings Institution.

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that in 1980 the O.E.C.D. countries will have a collective current account deficit of $50 billion and the non-OPEC developing countries will have a deficit of $70 billion, while OPEC will have a current account surplus of $100 billion. Thus, the size of the combined deficits of O.E.C.D. and developing countries will have risen from $27 billion in 1978 to $77 billion in 1970 and $120 billion in 1980. 2/ In the face of the task of financing these deficits, the $37 billion increase in I.M.F. quotas and lending resources is an essential first step toward an international response.

The role of the I.M.F. is all the more important because during this second wave of oil price increases, the private banks are not likely to be able to finance as large a portion of the borrowing needs of developing countries as they did following the first oil price increase in 1973-74, because this time they already have large exposures in these countries.

Those few skeptics who doubt the need for a quota increase might point to the fact that from 1977 to mid-1979, the I.M.F. was actually taking in more in repayments than it was lending out in new loans. It is highly likely that this pattern will reverse in 1980, given the sharp increases in current account deficits and the probable limits on the capacity of private banks in financing the developing countries. 3/

Some critics of the I.M.F. maintain that its resources have been underused in recent years because the conditions that the I.M.F. places on its lending are too strict. They contend that countries prefer to avoid the Fund, especially considering that its resources have been

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relatively small and therefore not sufficient to be worth the special policy changes necessary to meet I.M.F. conditions. These critics advocate a loosening up of the Fund's lending conditions, combined with a large increase in its available resources. 4/ It is noteworthy that even these critics join in the widespread consensus that there is a need for increasing the resources of the I.M.F.

In sum, there can be little doubt of the need for the proposed quota increase for the I.M.F. A more controversial aspect of the I.M.F. is the nature of its performance conditons attached to its lending.

Performance Conditions

There are two themes of critics of the I.M.F.'s lending conditions. Some spokesmen for developing countries, and some economists, believe the conditions are too strict, and that they follow orthodox economics too closely. Others, including some within the U.S. Congress, appear to feel that the I.M.F. lending conditions too often lead to hardship for the poor. I would like to address both of these themes. Let me state at the outset that I do not feel the evidence on either charge justifies a fundamental revision of the I.M.F. lending practices. There is considerable room for continuing review within the I.M.F. of the best possible strategies for economic stabilization, strategies that will avoid unnecessary losses of economic growth and unnecessary hardships on the poor. However, it would almost certainly be counterproductive for these very goals to hamstring the I.M.F. by legislating new rules

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that would either weaken the economic content of I.M.F. performance conditions, or prohibit the I.M.F. from lending on grounds that the apparent and short-run effects of a country's economic stabilization program would be unfavorable to the poor.

The Role of Conditionality

Member countries may borrow from the I.M.F. amounts up to 125 percent of their quotas at low interest rates (4 3/8 to 6 3/8 percent). The first of five equal "tranches" is available totally without conditions, on grounds that the country originally paid in this amount to the Fund in gold, hard currency, or SDRs ("Reserve tranche"). The remaining four "credit" tranches constitute net lending by the Fund, above what the country originally contributed in international reserves. Of these, the first credit tranche is available with practically no conditions; however, the second, third, and fourth credit tranches require successively stronger policy performance conditions, and are available in installments that are only paid if the "stand-by agreement" conditions are met. The rationale for performance conditions is that the I.M.F.'s funds are meant to be "revolving," not concessional grants, and appropriate economic policies are needed to ensure the borrowing country can repay the loans.

Typical conditions set for the higher credit tranches include some limit set on the rate of growth of domestic credit and the money supply, targets limiting government deficits, and sometimes, targets for reducing inflation or limiting external borrowing.

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Performance conditions play two vital roles. First, they act as a concrete target in the country's own planning for correcting a balance of payments deficit or reducing inflation. Second, they serve as a signal to the international banking community that the country is following acceptable economic policies and is a relatively secure credit risk. This second role is crucial. In my view, the most important thing to recognize about performance conditions is that they make it possible for the I.M.F. to grant its seal of approval to a country, thereby unlocking the much larger lending resources of the international banking community in addition to providing direct I.M.F. resources. Accordingly, it would be a serious mistake to weaken seriously the performance conditions that the I.M.F. applies. Watering down the conditions would make the I.M.F. seal of approval worthless, jeopardizing the role of the Fund in helping marshall private sector lending when it is needed.

Some critics want to weaken I.M.F. lending "performance conditions" because they believe the balance of payments problems of developing countries in recent years have been caused by external shocks, not by internal country policy. [5/] It is clear, however, that internal policies matter also. For example, after an outside inflationary shock in 1973-74, some developing countries, especially in Asia, followed economic policies that enabled them to bring down inflation once again, with no apparent loss of economic growth. Many other countries failed to do so because their internal policies kept domestic inflation at the new higher plateau set by the original external shocks. The same importance

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of domestic policy holds for balance of payments problems. One recent statistical analysis has found that in the 1970s domestic economic forces were responsible for balance of payments difficulties in developing countries to a greater degree than were external economic shocks. 6/

To recapitulate, meaningful performance conditions are an indispensable part of I.M.F. lending. Without them, private banks would no longer accept I.M.F. programs as evidence that countries are creditworthy. Moreover, domestic policy has been crucial for country performance in recent years, so internal policy conditions remain relevant even during this period of external economic shocks.

There is one caveat I would add. The performance conditions agreed to by the I.M.F. and a borrowing country during the early 1980s must take account of the large OPEC surplus. There must be deficits to mirror this surplus. If all countries try to eliminate their individual deficits, before OPEC raises its imports substantially, the result will be world recession. Therefore "performance conditions" in the early 1980s should probably provide greater leeway for balance of payments deficits than they have traditionally. Nevertheless, for many developing countries external debt is already so high that not too much leeway exists for continued high deficits. Instead, much of the world deficit that must mirror the OPEC surplus should be borne by the industrial countries, which have the creditworthiness to bear much larger increases in debt.

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Performance Conditions and the Poor

A second group of critics accepts performance conditions as a necessary part of I.M.F. lending, but maintains that these conditions should be designed so that I.M.F. stebilization programs do not hurt the poor.

In this area I am afraid that popular versions of some country experiences have led to overly simplistic perceptions. Vivid press reporta of rioting and even deaths connected with stabilization programs in Egypt and Peru have given the I.M.F. a reputation for heavy handed orthodox policies that cause suffering among the poor. Those who criticize I.M.F. programs as too hard on the poor typically have not considered the alternatives with any analytical depth. The fact of the matter is that often the only alternative is economic chaos, complete default on the country's debt, cut-off of vital imports, and much worse suffering by the poor than actually occurs under the I.M.F. stabilization program. Furthermore, it is myopic to look only at the short term impact of stabilization on the poor. By laying the foundations for sustainable future growth, stabilization programs are likely to mean a much higher standard of living for the poor in the space of three to five years than will the alternative of continued balance of payments and inflationary crisis. These medium term gains justify some short term hardships such as a decline in real wages.

The case of Peru illustrates how the I.M.F. has been blamed unfairly for imposing hardship on the poor. Many accounts of Peru's

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economic problems in the 1970s suggest that the I.M.F. imposed conditions that caused extreme economic suffering. My own analysis in a recent paper for a Brookings Institution conference finds that the real problem was not I.M.F. severity but the failure of domestic economic policy in Peru. 7/ Balance of payments problems became serious as early as 1974 and 1975, but the military government did not take serious corrective economic measures, and stick to them, until 1978. Instead, the regime borrowed abroad massively, kept up its high government budget deficits, and spent hundreds of millions of dollars on arms purchases abroad. By 1978 the country was in so extreme a condition, on the brink of default, that the remedial measures had to be severe. The government brought in a new economic team and took highly unpopular measures such as ending subsidies to gasoline and food sales, devaluing the currency, raising taxes and interest rates, and cutting government spending. If Peru had worked out a stabilization program with the I.M.F. as early as 1975, the program could have been much less severe and the adjustment less painful. The foreign private banks bear some responsibility, because their large lending in 1975-77 made it easier for Peru to delay corrective action; then, when the crisis became extreme, the banks cut off lending.

Despite the painful adjustment process in Peru in 1978, it is by no means clear that the poor suffered the most. In fact, those who suffered the most were white collar workers. Their real wages fell by 36 percent from 1970 to 1978. Blue collar workers had a 28 percent

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decline in real wages, but even the blue collar workers are not the poor of Peru. Working in the organized urban sectors, they are part of the middle class. The poor, the 50 percent of families with the lowest incomes, are primarily rural workers. The stabilization program does not seem to have borne down as heavily on them, and in fact the prices paid for farm products improved. The one group of the poor that did seem to suffer greatly were the unorganized urban workers such as petty street peddlars.

It does seem that Peru could have followed corrective policies that were more favorable to the poor. Increased taxes for upper income groups could have been relied on more. Some of the measures actually used were not overly hard on the poor, however. For example, raising the price of gasoline generally affected the middle income groups rather than the poor, who do not have cars.

Interventionism?

Should the I.M.F. have intervened in Peru and other similar cases on the issue of income distribution, adding as a new performance condition that tax, subsidy, and wage policies must be changed so that the burden of adjustment did not fall on the poor? I think the answer is no, for two reasons. First, it is extremely difficult on technical grounds to determine what the effect of a stabilization package will be on the distribution of income. For example, superficially it might seem that lowering real wages hurts the poor. However, if it is

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mainly the middle class that receives the urban sector wages that are lowered, and if some of the unemployed and rural poor might have a better chance at getting a job if the wage rate were lower (making it more attractive to firms to hire more workers), then lowering wages may improve rather than worsen the distribution of income. Similarly, it is necessary to examine an entire time sequence of up to five years or more to see whether one set of policies will really make the poor better off, or whether they only do so temporarily whereas another set of policies will make the poor better off over the time period as a whole despite an initial decline caused by adjustment measures.

A recent I.M.F. study of stabilization programs has found that it is extremely difficult to disentangle exactly what the income distributional consequences of stabilization programs really have been in specific past programs. 8/ In short, a first reason for not having the I.M.F. impose an additional "income distributional" performance condition on borrowers is that there would be a great deal of ambiguity in determining technically what measures would cause greater inequality and what measures would not.

Perhaps the more significant reason for refraining from such conditions is the issue of intervention in domestic affairs. The I.M.F. has just recently revised its regulations on lending conditionality because the developing countries felt the I.M.F. was intervening too much in essentially domestic choices, such as whether to achieve fiscal balance by raising taxes or by cutting subsidies. On March 2, 1979,

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the Executive Director issued guidelines providing that:

> "Performance criteria will normally be confined to (i) macro-economic variables, and (ii) those necessary to implement specific provisions of the Articles or policies adopted under them. Performance criteria may relate to other variables only in exceptional cases when they are essential for the effectiveness of the member's program because of their macro-economic impact. 9/

These guidelines rule out new I.M.F. conditions on internal decisions such as the incidence of stabilization measures by income class. It would be ironical to impose new conditions in this area just when the developing countries thought they had won new autonomy in the application of I.M.F. conditions. Moreover, in the broader context of North-South relations, the South has come to view with great suspicion restrictions imposed by the North in the name of basic human needs and the relief of poverty. Spokesman for the South consider such restrictions as interventionist and, often, as pretexts for not providing assistance where donors do not want to provide it in the first place. To extend this conflict to the I.M.F., an organization designed for short term balance of payments correction and not for concessional long term lending, would be to make even more difficult the effective functioning of the Fund at a time when the task of financing payments imbalances is already difficult enough.

We need to know more about the consequances of stabilization

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programs for income distribution and the incidence of absolute poverty. Legislative proposals designed to elicit further I.M.F. attention to, and studies on, this issue, are all to the good. It would be a serious mistake, however, to impose some rigid requirement that the Fund must include as an additional performance condition a specified policy on the question of internal income distribution. It is easy to foresee much havoc and little progress on behalf of the poor if, for example, an executive director were instructed to vote against an I.M.F. standby loan because it did not meet some prescribed condition on income distribution. 10/

Macro-economic Measures

Finally, I would like to point out that there remains a great deal of controversy among the experts about what are the appropriate macro-economic measures to take in stabilization programs. Traditional monetary analysis emphasizes the need for fiscal and monetary restraint, often combined with devaluation. Some economists (often loosely tagged as "structuralists") criticize I.M.F. performance conditions for following these traditional lines, and argue that the orthodox measures cause excessive unemployment and loss of production. If an analytical breakthrough were at hand, the appropriate course would be to keep I.M.F. "conditionality" but to revise its general features to take account of the new breakthrough. Unfortunately, the state of the art of economic analysis in this area remains one of unresolved

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controversy, and only a vaguely defined set of alternatives to the more traditional approach.[11/] In short, it is a non-sequitur to say that academic critiques justify terminating I.M.F. performance conditions, and it is premeture to say that these critiques provide the basis for reforming these conditions. It is clear, however, that the analytical effort must continue to seek a more complete understanding of how to achieve economic stabilization without undue sacrifice of short term economic growth and equity.

Conclusion

Because of inflation and the growth of world trade, it was necessary to raise I.M.F. quotas even before the oil price increase of 1979. It is all the more urgent to increase the quotas now, because the O.E.C.D. and non-oil developing countries will run current account deficits totaling over $100 billion in 1980 as the result of higher oil prices, and the I.M.F. must be strengthened to help deal with the financing task.

Despite popular press accounts depicting the I.M.F. as an oppressive enforcer of orthodox policies that cause hardship, it would be a mistake to weaken I.M.F. performance conditions on its loans. To do so would be to debase the I.M.F. "stamp of approval," thereby jeopardizing the Fund's key role in mobilizing the much larger resources of the private financial sector.

Nor should new performance conditions be imposed to force member countries to take measures that force the burden of stabilization

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adjustment onto the rich instead of the poor. The technical problems involved in determining the income distributional consequences of a given stabilization program are so severe that it would be pretense to assert that one set of stabilization policies would meet such conditions while another would not. Popular cases of alleged injury to the poor, such as the case of I.M.F. stabilization programs in Peru, turn out on closer analysis not to have been especially disadvantageous to the poor. Moreover, the I.M.F. has just revised the guidelines for performance conditions to stipulate less intervention in internal choices, not more. To extend the divisive issue of basic human needs to the arena of I.M.F. lending would incite considerable North-South friction and accomplish little for the poor in developing countries.

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FOOTNOTES

1. From 1959 to 1979 the value of world imports rose thirteen-fold, from $107 billion to approximately $1,384 billion. The proposed quota increase represents a rise of only five-fold over the same period, from $14.3 billion to approximately $75 billion (or 58 billion SDR). International Financial Statistics, May, 1978, December 1979; and National Advisory Council Special Report to the President and to Congress on Proposed Increases in Quotas of the International Monetary Fund, November, 1979, p. 16. An offsetting factor is that the I.M.F. will still hold 100 million ounces of gold after completion of its schedule of gold sales (returning one-sixth of original holdings to members and selling another one-sixth for aid to poor countries). Worth only $42/ounce at the official price but currently about $700/ounce at the market price, the I.M.F.'s gold resources are officially valued at only $4.2 billion but have a much higher market value ($70 billion at the market price, though not much could be sold without driving the price down).

2. Economic Report of the President (Washington, D.C.: Council of Economic Advisors, 1980), p. 169.

3. With prospective resources of 58 billion SDR and outstanding credits of only about 10 billion SDR (as of mid-1979), the Fund will have approximataly 48 billion SDR ($62 billion) of normal quota resources available to lend, not counting another $10 billion in the

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Witteveen facility (Supplementary Financing Facility). With a share of approximately one-fourth of total I.M.F. quotas, the non-oil developing countries will have access to approximately $15 billion through normal borrowing from the Fund. Though modest compared with annual current account deficits totalling $70 billion, this amount represents a significant potential contribution to financing the deficit of developing countries. The role of the I.M.F. is larger than these funds themselves suggest, because the Fund acts as a key to access to larger funds from the private capital market, as discussed in the text.

4. Sidney Dell, "The Balance of Payments Adjustment Process in Developing Countries: Report to the Group of Twenty-Four," UNDP/UNCTAD Project INT/75/015, 1979.

5. Ibid.

6. Stanley W. Black, "The Impact of Changes in the World Economy in the 1970s," in W. R. Cline and Sidney Weintraub, editors, Economic Stabilization in Developing Countries (Washington, D.C.: Brookings Institution, mimeographed, 1980).

7. William R. Cline, "Economic Stabilization in Peru, 1975-78," in Cline and Weintraub, editors, Economic Stabilization . . . .

8. Omotunde Johnson and Joanne Salop, "Distributional Aspects of Stabilization Programs in Developing Countries: A Preliminary Study with Special Application to Bolivia, Ghana, Indonesia, and the —

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Philippines," (Washington, D.C.: I.M.F., mimeographed, 1980).

9. I.M.F. Survey, March 19, 1979, p. 83.

10. In my view, such criteria are more relevant for long term development loans. For example, it would be plausible to veto a long term concessional loan for millions of dollars to a handful of wealthy ranchers, in order to preserve scarce funds for loans to small farmers. Macrocconomic policies of the kind relevant for short term balance of payments stabilization are far more complex. We do not have a clearly defined set of "regressive" and "progressive" policy alternatives in stabilization programs, so that it would be disingenuous to legislate requirements that presume that such clear cut alternatives are readily identifiable.

11. See William R. Cline and Sidney Weintraub, "Introduction and Overview," in Cline and Weintraub, editors, Economic Stabilization . . . .

Chairman NEAL. Thank you.
Mr. Moffitt?

STATEMENT OF MICHAEL MOFFITT, INSTITUTE FOR POLICY STUDIES

Mr. MOFFITT. Thank you very much, Mr. Chairman. It is an honor for me to be here to present my views to you on the important and timely subject of the expansion of the U.S. quota in the International Monetary Fund. I have followed the work of the subcommittee with great interest, particularly the hearings which were conducted last summer into the structure and operation of the Eurocurrency market. I hope that the present consideration of the expansion of the U.S. quota in the Fund will advance public knowledge of the genuine transformation in the structure of international banking and finance which has taken place during the last 10 to 15 years.

I believe which many of the issues which the subcommittee raised in relation to its discussions on the structure and operation of the Eurocurrency market and its implications both for economic stabilization policy in the industrialized countries as well as the LDC's bear on our consideration of the present legislation.

I have submitted a fairly lengthy statement for the record. What I would like to do is briefly summarize that now.

Mr. Chairman, I am in the unenviable position of following my friend Bill Cline, who states the case which he has stated about as well as it can be stated. But I would like to make three different points, which will contest what Dr. Cline has said.

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The first point I would like to make is that the stabilization programs of the International Monetary Fund do not work. They do not solve the balance-of-payments problems of the oil-importing LDC's.

The second point is that the stabilization programs of the IMF have in effect become a safety net for the exposure of the big commercial banks in the oil-importing LDC's.

And the third point which I would like to clarify is that Fund stabilization programs which I have looked at tend to impact particularly heavily on those members of society who are least able to bear the burden of the adjustment to international payments disequilibrium.

Mr. Chairman, I believe that these hearings are extremely timely. Recent economic developments, both at home and abroad, indicate that we are entering a new period of profound monetary instability. I do not share the administration's view that the problems which we confront over the next year or two are manageable without substantial policy changes or that we are making incremental progress toward solving them.

In recent months we have witnessed the resurgence of double-digit inflation, a new round of steep oil price hikes, the onset of a new downturn in our domestic economy, feverish speculation in foreign exchange and commodities markets, and warnings from our regulatory agencies about the stability of the international banking system.

As the U.S. economy slides into recession while inflation continues unabated, the effects of stagflation in the United States will filter throughout the world economy and will be felt acutely in the less-developed countries—LDC's—particularly those who are dependent on imported oil. From all indications, we are entering another vicious cycle of inflation, oil price hikes, recession, and massive debt accumulation by the oil-importing LDC's, which triggered widespread concern about the health of our financial system during the period 1974 to 1976.

As demand slumps in the United States and inventories build up, the LDC's will confront declining markets and foreign exchange reserves, even as the prices of the goods they import continue to rise. Many LDC's will face balance-of-payments crises worse than they did in 1973 to 1976, and will confront the choice of increasing their external indebtedness to maintain economic activity at politically acceptable levels or reducing their foreign borrowing, thereby plunging their economies into steep recession.

Mr. Chairman, it is my view that many factors contribute to present international monetary instability. The three main causes, in my view, are: One, the decline of the dollar as the world's key reserve currency; two, the relentless expansion of the relatively unregulated Eurocurrency market; and three, the huge debts which the less-developed countries owe to private multinational banks.

The disorder which plagues the international monetary system has domestic ramifications for stabilization policies in both the industrialized and the less-developed countries. The growth of the Euromarket has not only magnified the gyrations in foreign exchange markets, but has intensified inflationary pressures in the

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industrialized countries. Traditional economic stabilization policies have lost some of their effectiveness as a result of recent changes in the international monetary system.

Recently, for example, we have seen that the big commercial banks, particularly the top tier operating in the Eurocurrency market, have been able to blunt the effectiveness of the Federal Reserve action announced on October 6. During August and September, U.S. banks, anticipating future credit tightening, had been bringing in huge amounts of funds to the United States from their foreign branches. After the Federal Reserve Board had announced its new credit-tightening moves on October 6, the banks used this supply of funds to go on lending in excess of what the Federal Reserve Board considered desirable levels.

Deteriorating world economic conditions have made the large private bank loans to less-developed countries a major source of current monetary instability. No authoritative data on the precise amount of Third World indebtedness exists. But Irving Friedman, who is a senior international adviser at First Boston Corp., estimates that the total amount of LDC debt ranges between $400 and $450 billion. In nominal terms, the LDC's external debt quadrupled between 1970 and 1978.

Private banks account for an increasing share of the LDC's outstanding debt. Whereas in 1970 private banks accounted for less than 10 percent of the debt, by yearend 1978 they accounted for half. Brazil alone has a foreign debt in excess of $52 billion and may borrow an additional $15 billion this year in private capital markets to pay for the increasing cost of imported oil and to service its external debt.

The substantial level of outstanding LDC indebtedness is causing grave concern among bankers and bank regulators. Yet massive borrowing in private capital markets seems to have become a way of life for many countries. It is significant that in 1978, when the OPEC surplus shrunk to $6 billion from a high of $68 billion 4 years earlier, the nonoil LDC's still ran a combined current account deficit of approximately $31 billion. The real price of oil was actually falling in 1978. Yet the less-developed countries still recorded large deficits, which had to be financed.

When international inflation, oil prices, and interest rates resumed their upward climb in 1979, the LDC borrowing from the private banking system soared again. According to the Bank for International Settlements, the oil-importing less-developed countries increased their foreign borrowing by $15 billion during the first quarter of 1979. Now, however, conditions have changed dramatically. While the demand for credit continues unabated, interest rates in the major developed countries have chased each other upward, pushing up the cost of funds in the Euromarket.

David Rockefeller, the chairman of Chase Manhattan Bank, warns that the increasing cost of international credit, plus fears about the manageability of the debt of the oil-importing Third World, could result in "a potentially severe liquidity crunch and potentially a credit squeeze" in the next decade.

Recent developments suggest that private multinational banks may be unwilling to perform the bulk of the petrodollar recycling to deficit countries as they have in the past. Rimmer de Vries, a

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vice president of Morgan Guaranty Trust, has pointed out that: "This time the private banking system just can't handle the unaided recycling of petrodollars for financing of developing countries' rocketing balance-of-payments deficits."

Bank regulators in the United States and Japan are also pressuring their banks to scale down their lending to many less-developed countries. This concern about the potential vulnerability of the international banking system, I believe, lies behind much of the current impetus to expand the Fund's quotas.

Brazil, for example, is widely cited as a successful industrializing country with a strong growth and export performance. Yet, Brazil's foreign debt payments consume 60 percent of its export earnings. In 1979, the Government of Brazil took advantage of highly liquid Euromarket loans and borrowed heavily. But foreign bankers are starting to get concerned about the growth of Brazil's foreign debt. Serious doubts are surfacing about Brazil's ability to cover its financing gap for 1980.

At present the banks and the International Monetary Fund would prefer that Brazil undertake a stabilization program rather than finance its projected deficit for a year or two. The managers of the Brazilian economy have resisted this course because they are certain the IMF would force the Government to scale down its plans to grow its way out of its debt problems. In what follows I would like to examine in greater detail why countries like Brazil react this way to Fund stabilization programs.

I might also add that it appears that a high rate of economic growth is essential to maintain Brazil's transition from an authoritarian military regime to a more pluralistic and democratic society. slower growth in Brazil would inevitably increase the conflict over income shares, and in the present Brazilian context would probably mean increased repression to contain real wages.

In a recent speech to the Chase Econometrics Seminar, David Rockefeller used the following analogy to summarize the banks' concerns about the future of major borrowers like Brazil.

> The seascape facing these same nations in the days ahead, however, is markedly different and rather more threatening. What we see ahead are treacherous economic seas and gale-force financial winds, strong enough to capsize even large and well-manned ships, unless sails are reefed early and all hands are ready at their stations when the gale hits.

Mr. Chairman, if private banks begin to balk on recycling the bulk of export petrodollars, that will throw a larger financing burden on the IMF, which up until now has performed only a minor role in petrodollar recycling. It has become part of the conventional wisdom that the International Monetary Fund has provided the international economy with the bedrock of stability in recent years, while the private banking system has performed the bulk of the recycling. The IMF has supposedly provided an institutional framework to facilitate the international adjustment process.

Accordingly, when individual countries have borrowed in excess of what their international reserves can support, the International Monetary Fund intervened and established viable adjustment programs to restore equilibrium in the balance of payments. Indeed, the official view of the Fund is that only governments which refused to submit to IMF's discipline early enough in their balance-

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of-payments difficulties actually encountered problems in financing the deficits and managing their external indebtedness.

Clearly the administration envisions both a qualitative and a quantitative increase in the Fund's activities in the upcoming decade. Despite the administration's rosy assessment of the Fund's past performance, I urge member of this subcommittee to reexamine the record of the International Monetary Fund in combating global monetary instability before consenting to this increase in the U.S. quota in the Fund.

Such an examination, I believe, would lead to the conclusion that the International Monetary Fund is woefully inadequate to cope with contemporary financial disorders. There is no evidence that a mere increase in the level of the Fund's resources will enhance its ability to promote global monetary stability. Not only is the Fund ill-equipped to cope with some of the more pressing international monetary problems, such as exchange rate instability, in those crucial policy areas where it is active its policies are frequently destructive of the prosperity of individual Fund members as well as global prosperity in general.

The IMF's involvement in formulating and monitoring stabilization programs in the less developed countries is nothing new. In the 1950's the Fund established standby arrangements with a number of LDC's, especially in Latin America. And in the 1960's, this increased to roughly 22 standby arrangements per year. The less-developed countries account for the majority of these.

The use of Fund resources expanded considerably with the explosion of current account deficits of the nonoil less-developed countries after 1973. From 1974 to 1976, member countries drew unprecedented levels of resources from the Fund. However—and this is an important point—they did so out of special, temporary, or auxiliary facilities, rather than the normal credit tranche facilities of the Fund. Most of the increase in members' drawings in the period 1975 to 1976 came from the special oil facility, which was terminated in 1976.

Paradoxically, after 1973 the number of Fund standby arrangements declined. In the period following 1973, the Fund approved fewer standby arrangements than it did throughout the 1960's. As the Dell report, commissioned by the United Nations, points out: "There were only five cases of drawings beyond the first credit tranche in the years 1974 to 1976 among the entire Fund membership." Given the magnitude of the economic disturbances in the years after 1973, the Fund's contribution to the balance-of-payments adjustment process was minimal. After 1977, the absolute level of drawings on the Fund's resources declined precipitously.

Mr. Chairman, to speed up the agenda this morning, I will not detail the development of the relationship between private commercial banks and the IMF. It is described in my prepared statement.

The central issue in the debate over the future of the International Monetary Fund is the nature of Fund conditionality and its impact on member countries. Fund conditionality has become the main deterrent to the use of Fund resources by member countries.

Today the Fund's unique role vis-a-vis private banks plus the tightening of conditionality attached to upper tranche drawings

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has made the Fund a powerful supranational lender of last resort for debt-ridden LDC's. It is ironical that the cataclysmic events of the 1970's which gave the Fund its clout with the less-developed countries has also rendered its stabilization program farther removed from economic reality.

After 1973 the particular structural vulnerability to external crises that plagues most less-developed countries led to massive current account deficits which could no longer be ignored. As I have pointed out, in 1978, when the OPEC surplus was shrinking to a low from its 1974 levels, the LDC's still ran substantial deficits.

IMF programs neglect the fact that in many countries improving the trade balance requires structural change which can be only achieved in the process of genuine development. Instead, the Fund takes existing structures for granted and tries to force-feed economies into adjustment programs which cannot bring about stability.

The Fund's own analysis of its stabilization program confirms that Fund stabilization programs are becoming less, not more, effective in achieving their own aims. In a review of 21 standby arrangements in 18 countries during the 1973–75 period, T. R. Reichmann of the Exchange and Trade Relations Department of the Fund compared the aim of the programs with their actual results. Mr. Reichmann's results show only a 33-percent success rate for these 21 programs, and he credits exogenous factors with the successes as well as the failures. He concluded, and I quote:

> The magnitude of balance-of-payments disturbances and the existence of strong external factors seriously affected the design and implementation of the programs. As a result, of the 21 programs under review only 7 are considered successful, and even then only with some qualifications.

Reichmann found that in 14 of the 21 standby arrangements, the countries' balance-of-payments position improved. But he stresses that the improvement resulted from factors independent of the stabilization program.

It is significant that an earlier analysis by Reichmann and Richard Stillson, also of the Exchange and Trade Relations Department of the Fund, suggested a higher rate of success for stabilization programs on balance of payments and other criteria. Of 79 selected cases between 1963 and 1972, they found that 76 percent of the stabilization programs had achieved their primary goals. And as I said before, what the Fund's own analysis suggests is that Fund stabilization program have been less effective in restoring balance-of-payments equilibrium after 1973 than they were before.

The Fund's shortsightedness is evident in the recent stabilization program with Peru. I find it rather puzzling that Peru is frequently cited as a case in which a Fund stabilization program has led to a substantial improvement in the country's outlook. It is true that today Peru's economic outlook is a lot brighter that it was in 1978 when the Fund and the Peruvian Government mapped out a stabilization program.

However, I think it taxes the imagination to suggest that the Fund program accounts for the fact that copper is selling for $1.35 a pound and that the value of Peru's oil exports have also risen. This is, in fact, what has accounted for the improvement in Peru's external position. From a position of a severe foreign exchange shortage 2 or 3 years ago, Peru now faces the opposite problem of

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trying to find a way to sterilize this inflow of foreign exchange so that it doesn't drive inflation through the ceiling.

What I want to emphasize is that in the case of Peru the Fund's preoccupation with short-term equilibrium in the balance of payments resulted in the imposition of a program which has serious impacts on the welfare and the livelihood of the people of Peru, and yet Peru's economic recovery had almost nothing to do with the essentials of the stabilization program itself.

This would suggest that we need a genuine medium-term facility to facilitate international adjustment which does not demand the short-term sacrifice which the program for Peru inflicted on the people of Peru.

Another illustration of a recent stabilization program which had results somewhat different than the Fund desired was the 1979 stabilization program granted to the tyrannical Somoza government of Nicaragua. Two months before the overthrow of Somoza, the IMF's Board of Directors approved an 18-month standby arrangement with Nicaragua, thereby allowing the Government to purchase SDR 34 million from the Fund. In the confidential staff recommendation accompanying the standby arrangement, the Fund staff noted that the program carried "substantial risk," yet considered the details of the program, and I quote, "technically sound."

The program was approved on May 14, and on July 19 the Somoza regime was overthrown. The question here—and I want to stress this—is not whether the Fund should grant standby arrangements to shaky governments, but how a competent staff could consider a program "technically sound" which did not take account of the economic effects of a civil war going on in Nicaragua.

The cornerstone of the program for Nicaragua was an improvement in the financial position of the public sector. Yet by the time the program was mapped out and approved, the Somoza government had totally lost legitimacy. How was the central government supposed to improve its financial position when 80 to 90 percent of the population had taken up arms in a civil war to get rid of the government?

One Latin American central bank president called the stabilization program for Nicaragua, the ultimate farce of the Fund. Can you imagine putting together a typical Fund program, pretty awful in the best of times, in the middle of a civil war? Is that nonsense or is that nonsense?

To conclude, Mr. Chairman, I want to say that Fund stabilization programs are not only increasingly removed from political and economic realities, they are fundamentally regressive.

The very nature of Fund stabilization programs tends to throw a disproportionate share of the burden of sacrifice on those who can least afford it. The programs are not, as the Fund charter suggests, supportive of national prosperity. They promote national retrenchment and austerity. Even governments which try to do so would find it difficult to meet the basic human needs of their citizens within the constraints of a Fund stabilization program.

For example, the Manley government of Jamaica and the IMF have reached an impasse in their renegotiation of Jamaica's 3-year stabilization program. In recent years, Jamaica has been wracked

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by the same succession of economic disturbances which have burdened most oil-importing, less-developed countries.

In May 1978, Jamaica entered into an Extended Fund Facility and qualified for a Supplementary Financing Facility in 1979. Recently, however, higher interest rates and rising import prices, especially oil, have caused Jamaica to exceed the IMF's targets, both on the external deficit and on fiscal deficit.

In 1980, Jamaica will earn approximately $672 million in export revenues. Yet, to pay for the cost of imported oil and service its external debt, Jamaica will spend $691 million, or somewhat more than it will earn in exporting; 54 percent of Jamaica's export earnings now go to service its external debt.

Negotiations between the Fund and Jamaica have broken down because the Fund has requested budget cuts of more than $100 million. The Jamaican Government estimates that the cuts the Fund is asking for would translate into the loss of thousands of jobs.

During the first year of the extended Fund facility, begun in May 1978, according to the World Bank, real wages in Jamaica fell by one-quarter to one-third. Real per capita consumption fell by 13 percent in 1978. As in the case of Peru, the Fund program has not generated real economic growth or the expansion of employment. Unemployment still victimizes more than 25 percent of Jamaica's labor force.

How can Jamaica be asked to continually tighten its belt to satisfy the conditionality of the International Monetary Fund when there are no more belt holes left to tighten?

Thank you, Mr. Chairman.

[Mr. Moffitt's prepared statement follows:]

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STATEMENT BY

MICHAEL MOFFITT
INSTITUTE OF POLICY STUDIES

BEFORE THE SUBCOMMITTEE ON INTERNATIONAL TRADE,
INVESTMENT AND MONETARY POLICY OF
THE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
HOUSE OF REPRESENTATIVES
FEBRUARY 6, 1980

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Mr. Chairman, I welcome this opportunity to present my views to this Committee on the important and timely subject of the authorization of the proposed SDR 4.2025 billion increase in the U.S. quota in the International Monetary Fund (H.R. 5970). These hearings present Congress and the public with an important opportunity to engage in a serious dialogue regarding the objectives of U.S. participation in the International Monetary Fund (IMF) and, indeed, in the international monetary system itself.

During this past year, members of this Committee, and in particular the ranking minority member, Rep. Leach of Iowa, have performed an important public service by conducting an in-depth investigation into the structure of the Eurocurrency market. The seemingly arcane features of international finance, the foreign activities of U.S.-based multinational banks and the growing power of the IMF are issues which should concern every American who is troubled by raging inflation, nagging unemployment, our declining dollar, world hunger and chronic economic instability. Though the specific focus of these hearings is the issue of expanding the U.S. quota in the Fund by approximately $5.5 billion, I want to emphasize that we cannot consider the operations of the IMF in isolation from the other issues which dominate our

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national and global economic agenda. In the past decade we have witnessed a genuine transformation of the international financial system which we are only beginning to understand the policy implications of. I hope that these hearings will resume the long-overdue inquiry into the meaning of these changes begun last summer during the consideration of Rep. Leach's Euro-currency Market Control Act.

Mr. Chairman, let me emphasize the timeliness of these hearings. Recent economic developments at home and abroad indicate that we are entering a new period of profound monetary and financial instability. In recent months we have witnessed the resurgence of double-digit inflation, a new round of steep oil price hikes, the onset of a new downturn in our domestic economy, a dramatic rise in interest rates, feverish speculation on foreign exchange and commodities markets and warnings from our regulatory agencies about the stability of the international banking system. As the U.S. economy slides into recession while inflation continues unabated, the effects of stagflation in the United States will filter throughout the world economy and will be felt acutely in the less developed countries (LDCs).

From all indications, we are entering another vicious cycle of inflation -- oil price hikes -- recession -- and massive debt accumulation by deficit-ridden LDCs which triggered widespread concern about the health of our financial system during the period 1974-1976. As demand slumps and inventories build up, LDCs will confront declining markets and shrinking foreign exchange reserves even as the prices of the goods they import continue to rise. Many LDCs will face balance of payments crises much worse than they did from 1973 to 1975 and will confront the choice of increasing their external indebtedness to maintain economic activity at politically

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acceptable levels or reducing their foreign borrowing, thereby plunging their economies into steep recessions.

Before the situation gets out of hand, we must find answers to some important questions. One, what is the exact magnitude of the LDCs outstanding indebtedness to their public and private creditors and how will a new round of heavy borrowing in international credit markets affect the health of the international financial system? Are private banks prepared to recycle the bulk of surplus petrodollars to oil-importing LDCs again and how will the current levels of indebtedness of some major borrowing countries and the banks' own exposure influence this decision? What provisions, aside from the creation of the Witteveen Facility, has the IMF made to cope with the increasing number of countries likely to need external financial assistance and what kind of adjustment will the Fund advise countries to undertake in response to these international economic fluctuations? What is the success record of the "stabilization programs" of the IMF and what is the impact on member countries of Fund conditionality on development in the LDCs? Finally, what is the relationship between these short-term policies, including the expansion of the Fund's quotas, and longer-term U.S. efforts to create a viable international monetary system?

Mr. Chairman, let me caution against a hasty decision on this legislation expanding the U.S. quota in the Fund. I, for one, would not like to see an expansion of the U.S. quota without a serious and critical examination of the role which the International Monetary Fund plays in the world today. In my view, there are many questions regarding the operations of the Fund which neither the Fund's management nor the administration have adequately

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addressed. These uncertainties alone impede our efforts to achieve our objectives of full employment and price stability at home and development and prosperity abroad.

The Crisis in the International Monetary System

Any meaningful discussion of the International Monetary Fund must begin with an analysis of the profound crisis which currently grips the international monetary system. The international monetary system created at Bretton Woods lies in ruins and the failure to create a new system threatens our national and international prosperity. The world economic order faces more serious challenges today than at any time in its history. Neither the IMF nor any other institution is fully equipped to cope with the potential economic and financial disturbances which may result.

The administration assures us that existing international monetary problems are manageable and that it is making incremental progress towards solutions, as demonstrated by the proposed substitution account in the IMF. Yet since the Carter administration took office the international financial system has been jolted by two near panics.[1] From mid-1977 until the enactment of the November 1, 1978 dollar rescue program, the U.S. dollar declined roughly 35% against the Swiss franc, more than 30% against the yen, and nearly 20% against the mark.[2] The dollar depreciated 6% in October 1978 alone. Only when the decline of the dollar had, in the words of Business Week "threatened to precipitate an international financial crisis", did the administration act.[3] The massive run on the dollar, which virtually destroyed confidence in the dollar as the key reserve asset of the international monetary system, subsided only after the administration assembled a $30 billion dollar currency swap fund and pushed up interest rates.

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The success of the November 1 program, which featured unprecedented intervention by the Federal Reserve Board into foreign exchange markets in support of the dollar, was short-lived. Less than a year later the dollar had again plunged to the depths of October 1978. The situation was so grave that Federal Reserve Chairman Paul Volcker felt compelled to leave the annual meetings of the International Monetary Fund and the World Bank in Belgrade, to return to Washington to assemble a new dollar rescue program.

The actions which Chairman Volcker announced on October 6, 1979 recognized the scope and extent of the present crisis, but these actions have thus far failed to stabilize the foreign exchange markets or slow our domestic inflation rate. Despite rising interest rates and the conservative reorientation of our domestic economic policy, the U.S. inflation rate for 1979 exceeded 13%, the highest the U.S. has experienced since 1946. Since mid-1979, the dollar and other major paper currencies have been subject to periodic pressures as investors and speculators move their assets out of these paper currencies and into gold, silver and other commodities. Moreover, the danger persists that the assault on the dollar could resume at any time. In the words of Business Week:

> With hundreds of billions in 'stateless' money moving about in the offshore Euromarkets outside the control of central banks, there is no limit to how far the dollar could plunge if private investors and speculators lost confidence in the U.S. currency.[4]

Many factors contribute to present international monetary instability. The three main causes are the decline of the dollar as the world's key reserve currency, the continuous expansion of the unregulated Eurocurrency market, and the huge debts which the less developed countries owe to private multinational banks. Together they are exerting tremendous strain on the international monetary system.

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The huge "dollar overhang", resulting from more than two decades of U.S. balance of payments deficits, has been a destabilizing force on the international monetary system since the mid-1960s. Ironically, the dollar, once the bedrock of the post-war economy, has become a particularly appealing target for speculative selling. The reason why was aptly stated by the noted international economist Robert Triffin:

> The continued outflow of dollars abroad has piled up an enormous indebtedness (often called "overhang") of foreign dollar balances, rising from about $78 billion in 1969 to more than $370 billion by mid-1978, which private holders are more and more tempted to unload on the market, and which central banks are absorbing, more and more reluctantly, to slow down the depreciation of the dollar vis a vis their own currencies and the consequent damaging impact on their own trade, production and employment.[5]

The dollar's instability has been exacerbated by the relentless expansion of the unregulated Eurocurrency market. In the past decade, we have witnessed a genuine transformation in the structure of international banking and finance. Most of these changes have occurred in the Eurocurrency market, which is dominated by a few large U.S., European and Japanese banks. Estimates differ as to the exact magnitude of the Eurocurrency market, the most common being a gross size of approximately $960 billion, but there can be no doubt that in recent years the Euromarket has grown at a faster rate than the money supply of the biggest economy in the world, the United States. As Governor Wallich has testified before this Committee, the Eurocurrency market grew at an average annual rate of roughly 18½% from 1974 through 1978, or more than two to three times as fast as M^1 or M^4.[6]

The emergence of the Eurocurrency market as the fastest growing source of international liquidity has aggravated the problem of exchange rate instability. The internationalization of the U.S. banking system has created

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a global money market which functions 24 hours a day. Monetary instability is perpetuated by large, short-term capital flows in and out of the world's major paper currencies. It must be emphasized that the volume of foreign exchange trading in the world's markets today far exceeds the amount required to finance world trade. In 1977, the global volume of foreign exchange transactions exceeded $50 trillion, whereas the total volume of world trade for 1977 was approximately $1 trillion.[7] Foreign exchenge trading has become an end in itself, as large corporations, banks and individual depositors shift their holdings in and out of different currencies seeking speculative profits.[8]

Some of the biggest U.S. corporations and banks have reaped large annual profits by capitalizing on the dollar's vulnerability. In 1978, for example, Citibank, New York's leading bank, earned nearly one-quarter of its net income on foreign exchange trading alone. More than half of that came in the 4th quarter of 1978, when the dollar threatened to drop down out of sight. For Citibank, 1978 brought an increase of 700% in profits from foreign exchange trading over 1977. Chase Manhattan recorded a 54% gain in foreign exchange profits in 1978.[9] The interbank market has become a veritable thermometer of heavy speculative activity, as evidenced by the large increase in interbank transactions in the last quarter of 1978.[10]

The tremendous increase in the amount of speculative activity in foreign exchange markets also increases the dangers of a major international financial crisis. In 1974, the Herstatt Bank of West Germany and the Franklin National Bank collapsed following the large losses each incurred from excessive speculation in foreign exchange markets. At that time, bank profits were down and branch and subsidiary managers were under pressure from the parent banks to increase profits through foreign exchange trading. While most banks and

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corporations have since enhanced internal monitoring systems to ensure that branch managers cover risks and positions in foreign exchange, it would be foolhardy tothink that the banking system is now immune to such occurrences.

The very nature of the Eurocurrency market increases the possibility that a crisis can spread quickly from one bank to another. The interbank market accounts for approximately 40% of all Euromarket assets and liabilities. While the size of the interbank market no doubt exaggerates the gross size of the Euromarket,[11] it also increases the possibility that difficulties in one bank can be rapidly transmitted to others.

The disorder which plagues the international monetary system has domestic ramifications for both the United States and its major trading partners. The growth of the Euromarket has not only magnified the gyrations in foreign exchange markets but has also intensified inflationary pressures in the industrialized countries. Our domestic inflation rate ratchets upward with every decline in the value of the dollar and the spillover of funds from the foreign exchange markets into gold, silver and other commodities markets perpetuates inflationary expectations. Concurrently, rising interest rates resulting from the Federal Reserve Board's action to rescue the dollar and contain inflation have increased the possibility of a steep fall in economic activity and rising unemployment in 1980. Despite rising unemployment and layoffs, the unsteady state of the dollar has impacted heavily on the administration's anti-inflation policies. "Although its action can only increase the severity of the developing recession," Business Week notes, "the Fed felt compelled to shore up the dollar on foreign exchange markets. The gnomes of Zurich, it would seem, are now setting U.S. monetary policy."[12]

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Traditional economic stabilization policies have lost some of their effectiveness as a result of changes in the international monetary system. The absence of the kinds of regulations over Euromarket transactions which restrict domestic banking operations, such as reserve requirements, has reduced the Federal Reserve's and other central banks' control over domestic monetary policies. The first evidence of this appeared more than a decade ago. In 1968 and 1969 the Federal Reserve Board tightened domestic credit to cool Vietnam war-related inflation. However, overseas branches of U.S. banks kept on lending funds back into the United States, thereby undercutting the Fed's credit tightening moves.[13]

Recently U.S. banks have relied on Euromarket funds to blunt the effectiveness of the drastic Federal Reserve action announced on October 6. During August and September, U.S. banks had been bringing large amounts of funds into the U.S. from their foreign branches. After the Federal Reserve Board had announced its new credit tightening moves the banks used this supply of funds to go on lending in excess of what the Federal Reserve Board considered desirable levels. In the words of the Wall Street Journal:

> ...American banks correctly anticipated the credit squeeze introduced by the Fed October 6 -- which included an 8% reserve requirement on Eurodollar borrowings -- and brought a huge amount of funds back to the United States to build their deposit bases....hence, U.S. banks were seemingly about to build up the stock of lendable funds before the credit squeeze started...the buildup in funds by U.S. banks in London may partly explain why the U.S. credit squeeze has been less severe than some bankers originally anticipated.[14]

Deteriorating world economic conditions have made the large private bank loans to less developed countries in recent years another source of current international monetary instability. Until recently, most LDCs had not borrowed heavily from private multinational banks.

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In the aftermath of OPEC's crude oil price hikes, banks were as eager to expand their lending as Third World countries were to borrow. The deep recession that began in 1974 depressed loan demand in the developed countries and sent banks scrambling for outlets for the $40 billion which OPEC poured into their European and offshore branches. Every bank that wanted the OPEC cash had to find new outlets for loans and other investments. The major banks' international operations, both in terms of assets and profits, were growing much faster than domestic assets and profits. By 1977, Citibank, New York's leading bank, earned 27% of its income in Latin America and another 18% in Asia, Africa and the Middle East. In 1977, Citibank's Brazilian operations produced 20% of the bank's after-tax earnings.[15]

No authoritive data on the precise amount of Third World indebtedness exists, but Irving Friedman, a senior international advisor at Citibank, estimates that the total amount of LDC debt ranges between $400 and $450 billion.[16] In nominal terms, the LDCs external debt quadrupled between 1970 and 1978. Between 1974 and 1978 countries in Latin America and the Caribbean made net borrowings exceeding $85 billion.[17]

Private banks account for an increasing share of the LDC's outstanding debt. Whereas in 1970 private banks accounted for less than 10% of the total outstanding debt, by year-end 1978 they accounted for about half. Irving Friedman estimates that in 1978 private financial institutions loaned about $31 billion to LDC governments while official institutions disbursed only about $20 billion.[18] Brazil alone has a foreign debt of more than $52 billion and may borrow an additional $15 billion. this year, most of it coming from private capital markets.[19]

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The substantial level of outstanding LDC indebtedness has caused grave concern among bankers and bank regulators. Yet massive LDC borrowing from the private banking system seems to have become a way of life for many countries. It is significant that in 1978 when the OPEC surplus shrunk to $6 billion from a high of $68 billion four years earlier, the non-oil LDCs still ran a combined current account deficit of approximately $31 billion. The real price of oil was actually falling in 1978 due to the deterioration of the dollar, and yet the LDCs still recorded a large deficit which had to be financed. When international inflation, oil prices and interest rates resumed their upward climb in 1979, LDC borrowing from the private banking system took off dramatically. According to the Bank for International Settlements, the non-oil LDCs increased their foreign borrowing by $15 billion during the first quarter of 1979, which was significantly higher than their foreign borrowing for the first six months of 1978.[20] It should be edded in passing that low real interest rates, the anticipation of higher interest rates and the building up of some countries' international reserves accounted for some of this borrowing.

Now, however, conditions have changed dramatically. Interest rates in the major developed countries have chased each other upward pushing up the costs of funds in the Euromarket. The increasing costs of international credit have coincided with negative economic developments thereby increasing the likelihood that many LDC's will be forced to borrow heavily over the next two years. The increasing costs of international credit, plus renewed fears about the manageability of the LDC debts, warns David Rockefeller, the chairman of Chase Manhattan, could result in a "potentially severe liquidity crunch and potentially a credit squeeze" in the next decade.[21]

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These developments suggest that private multinational banks may be unwilling to perform the bulk of recycling to deficit countries in the future. As Rimmer de Vries, a vice president of Morgan Guaranty Trust, has pointed out, "this time the private banking system just can't handle unaided recycling of petrodollars, or financing of developing countries' rocketing balance of payments deficits."[22] This involves difficult choices for the banks. On the one hand, with the OPEC surplus reaching $100 billion in 1980, many banks will find the huge surplus too appetizing to forego. On the other hand, an increase in these liabilities means that the banks have to find new outlets for loans and other investments, just as they did in 1974. Even though the banks are no longer novices in the LDCs, the staggering level of LDC indebtedness has made the banks wary of increasing their exposure in a number of countries.

Bank regulators, notably in the U.S. and Japan, are also pressuring their banks to scale down their lending to many LDCs and, in any case, not to extend the percentage of their portfolios beyond 10% for any one country. These fears about the potential vulnerability of the international banking system, I believe, lie behind much of the impetus to expand the Fund's quotas. The same concerns underlie the drive to discourage countries from financing their deficits in 1980 and 1981 by borrowing in private capital markets and instead compel them to undertake Fund stabilization programs early.

Brazil, for example, is widely cited as a successful industrializing country with a strong growth and export performance. Yet Brazil's foreign debt payments consume 60% of its export earnings. In fact, Brazil must

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borrow roughly $15 billion in 1980 to keep pace with the rising costs of imports and of debt servicing.[23]

In 1979, the government took advantage of the highly liquid Euromarket and borrowed heavily, but foreign bankers are starting to get worried about Brazil. Interest rates in the Euromarket have risen, and serious doubts are surfacing about Brazil's ability to cover its financing gap for 1980 and beyond. The bankers' worries about Brazil have not gone unnoticed in the International Monetary Fund. One high Fund official told me recently, "I am not personally worried about Brazil, but if the banks are worried, I'm worried." The danger, this official points out, is that the banks might cut back their lending to Brazil too quickly, leaving the country in a void without adequate foreign exchange.

At present, the banks and the Fund would prefer that Brazil undertake a stabilization program rather than finance its projected deficit for a year or two. Presumably, this would reassure the banks that Brazil is on a sound financial path and encourage them to supply whatever funds are needed to fill the financing gap. The managers of the Brazilian economy have resisted this course because they are certain that the IMF would force the government to scale down its plans to grow its way out of its debt problems. A high rate of growth in Brazil is also essential to maintain the country's transition from an authoritarian military regime to a more pluralistic and democratic society. Slower growth inevitably increases conflict over income shares which, in the present Brazilian context, would mean increased repression to contain real wage increases.

In all likelihood, Brazil will be able to raise the foreign borrowing it needs to maintain an acceptable level of growth. For major borrowers

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like Brazil, the sheer amount of private bank exposure in these countries gives them a measure of leverage over the banks. Not even a Citibank could stand idly by as the source of more than 10% of its earnings threatened the bank with default. The banks have already loaned so much to Brazil that they have to keep on lending so that the country can service its debts. Yet the more Brazil's debt grows, the less attractive it looks as a major borrower.

In a recent speech to the Chase Econometrics Seminar, David Rockefeller has used the following analogy to summarize the banks' concerns about the future of major borrowers like Brazil:

> The seascape facing these same nations in the days ahead, however, is markedly different -- and rather more threatening. What we see ahead are treacherous economic seas and gale-force financial winds, strong enough to capsize even large and well-manned ships -- unless sails are reefed early, and all hands are ready at their stations when the gale hits.

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If the banks begin to balk on recycling, that will throw a larger financing burden on the IMF, which up until now has performed only a minor role in petrodollar recycling. It has become part of the conventional wisdom that the International Monetary Fund has provided the international economy with a bedrock of stability in recent years. While the private banking system has performed the bulk of the petrodollar recycling, the IMF has supposedly provided an institutional framework to facilitate the international adjustment process. Accordingly, when individual countries have borrowed in excess of what their international reserves and export earnings could reasonably support, the International Monetary Fund intervened and established viable adjustment programs to restore equilibrium between member countries' supply and demand for foreign exchange. Indeed, the official view of the Fund is that only governments which refused to submit to IMF discipline early enough in their balance of payments difficulties actually encountered problems in financing the deficits and managing their external indebtedness.

Now, the Fund argues that with the expansion of its quotas from approximately SDR 39 billion to SDR 58 billion, plus the addition of the Supplementary Financing Facility, it will be even better equipped to cope with a new round of balance of payments crises that may materialize in the early 1980s. Apparently this is also the administration's view. In fact, one of the major claims made by the National Advisory Council on International Monetary and Financial Policies' recent Special Report on the proposed increases in the quotas of the Fund, is that:

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> This increase in resources is needed to maintain the IMF's ability to meet demands during a period of rising international trade and financial transactions, and, especially, during a period of rapidly increasing global payments imbalances and potential strains on the international monetary system. 24

Similarly, the Treasury Department suggests in a recent report that:

> As the central monetary institution, the IMF is the principal source of official multilateral balance of payments financing. In a very real sense the Fund acts as the financial back-stop of the system. It serves as the lender of last resort for countries experiencing financial difficulties. The Fund promotes the corrective measures required to achieve effective balance of payments adjustments. 25

It is clear that the administration envisions both a qualitative and a quantitative increase in the Fund's activities in this decade. Despite the administration's rosy assessment of the Fund's past performance, I urge members of this Committee to re-examine the record of the International Monetary Fund's operation in combatting global monetary instability in the past decade before consenting to this new increase in the U.S. quota in the Fund. Such an examination, I believe, would lead to the conclusion that the International Monetary Fund is woefully inadequate to cope with contemporary global economic and financial disorders. There is no evidence that a mere increase in the level of the Fund's resources will enhance its ability to act as a force for greater economic stability in the early 1980s. Not only is the Fund ill-equipped to cope with some of our more pressing international monetary problems, such as chronic exchange rate instability and large payments inbalances, in those policy areas where it is active, its policies are frequently destructive of the prosperity of individual Fund members as well as global prosperity in general.

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In this section of my testimony, I will contrast the founding principles of the International Monetary Fund, as expressed in the Articles of Agreement adopted at Bretton Woods on July 22, 1944, as modified by amendments to the Fund's Articles in recent years, with its actual performance.

Theoretically, the International Monetary Fund is supposed to function as the central institution of the international monetary system. Yet, if we examine closely the dramatic changes which have taken place during the 1970s, it appears that the International Monetary Fund is progressively losing its influence over many of the most important developments taking place in the international monetary system--or"non system"--as some critics have described it. The result is that, more and more, the IMF looks obsolete as the central institution of the international monetary system.

This can be illustrated by contrasting the Fund's recent performance with the founding principles set out in the Bretton Woods Articles of Agreement of 1944. Among the purposes detailed in Article I:

> --To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members....
>
> --To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.
>
> --To assist in...the elimination of foreign exchange restrictions....
>
> --To give confidence to members by making the Fund's resources temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.

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> --...to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members. 26

At first glance, it might appear that the Fund has been relatively successful in fulfilling these purposes for much of the post-war period. Most countries which participate in international trade and investment have, to one degree or another, liberalized restrictions on both foreign trade and capital movements. This liberalization contributed mightily to the unprecedented growth of international trade in the 25 years following the end of the Second World War. From 1962 to 1972, the volume of world trade increased by 9% annually. This expansion of international trade contributed significantly to the recovery of Western Europe and Japan and sustained high rates of growth in most developed countries from the end of the war to the early 1970s. In addition, the strong growth performance of the developed countries led to an impressive growth rate in a number of LDCs. Brazil, Mexico, Singapore, South Korea, Taiwan and others all registered growth rates for some of the post-war period which matched or exceeded those of the major developed countries.

While this seems to lend credence to the assertion that the IMF has lived up to the hopes of its founders, we must ask how much credit the IMF can claim for this impressive economic performance The Fund certainly played a role in shaping the post-war climate toward freer trade and capital flows, but there is little evidence that the Fund was principally responsible.

To begin with, some of the major structural problems of the inter-war period were left unresolved at Bretton Woods. Theoretically, one of the aims of the Bretton Woods negotiations was to create a set of institutional

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mechanisms which would both serve American interests and finance reconstruction and recovery in Western Europe. For example, Keynes had argued that the preponderant role of the United States in the world economy following the First World War had not been matched by an outflow of resources from the United States, thereby leading to a "dollar shortage" abroad. Bretton Woods did not resolve the problem; immediately after the war, the dollar shortage reappeared. What ended the dollar shortage, as the British economist Thomas Balogh has argued, was the Cold War which induced the Truman administration to facilitate large flows of capital to Western Europe under the Marshall Plan and other foreign assistance programs.[27] Marshall Plan aid, military spending and direct foreign investment by U.S. multinational firms, not the funds provided by the World Bank or the IMF, provided Europe with the liquidity to finance recovery. Without the infusion of massive amounts of liquidity independent of the Bretton Woods institutions, the post-war economic recovery would have been significantly weaker than it actually was.

This is not to deny that the Fund lent institutional support to the process, especially in the area of trade and exchange liberalization, but on the whole, the Fund played a relatively minor role in the early post-war period. In fact, one of the preconditions of the Marshall Plan was that recipients were precluded from drawing on Fund resources. Thus, the "total drawings from the Fund declined from $467.7 million in 1949 to zero in 1950. Total drawings did not exceed the 1947 level again until 1956."[28] While the Fund did encourage the Europeans to speed up the pace of trade and exchange liberalization, it was capital which the United States made available to Europe that facilitated the attainment of these objectives.[29]

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If the Fund played a minimal role in launching the post-war recovery, there are also serious questions as to how "balanced" this post-war trading system proved to be. While Europe and Japan recovered and went on to build diversified industrial economies, the Bretton Woods system hardly served the LDCs' interests well. This is not surprising, since many African, Asian and Caribbean nations did not achieve political independence until after the war. They had been represented at Bretton Woods by proxy, and it would require stretching the imagination to suggest that the European colonial powers went to Bretton Woods with the interests of the colonies in mind.

To the extent that the Bretton Woods system facilitated high rates of economic growth and the growth of trade, it also contributed to some economic growth in some LDCs. However, the fruits of economic progress have been distributed very unequally among different countries and within most of these countries as well. Progress in most LDCs has been erratic and inequitable. Many countries did not diversify, but remained exporters of primary agricultural and industrial commodities. Frequently, progress was confined to a few industrial centers and agriculture stagnated, contributing to increased dependency on imported foodstuffs.

It is frequently overlooked today that many Third World countries were mired in stagnation and crisis long before the dramatic economic disturbances of 1973-75. The structure of world trade was already seriously unbalanced when the 1970s began. The trading performance of most LDCs has been lackluster, especially given the steady liberalization and growth of trade that occurred. During the decade 1962-1972, the exports of the developed industrial countries grew at 9% per annum, or nearly 40% faster

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than the exports of the non-oil developing countries.[30] Thus, despite the progress of some countries--Brazil, Mexico, Argentina, Taiwan, South Korea, Singapore--the oil-importing LDCs' share of world trade has actually declined since 1950. From 1960 to 1975, the non-oil LDCs' share of world trade declined from 14.8% to 11.1%.[31] Even in raw materials, which account for most LDC exports, the LDCs' market share declined relative to that of the USSR, Canada and Australia.[32] The accumulation of debt in the LDCs had become a major problem long before the oil crisis.[33] Perhaps most tragically, development in most cases did not filter down to rural and marginalized urban groups. Incomes in these countries became more, not less, concentrated. Malnutrition, illiteracy, and underemployment grew and multiplied.

Thus, it involves considerable exaggeration to claim that throughout the post-war boom the Fund was responsible for facilitating "the expansion and balanced growth of international trade,...and the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members...."[34]

The claim that the Fund promotes greater exchange rate stability is also debatable. Buoyed by the post-war boom, the fixed exchange rate system worked relatively well until the mid-1960s. However, Robert Triffin had predicted as early as 1959 that there was a fatal conflict between dollar convertibility into gold and its role as the key reserve asset in the Bretton Woods monetary order. Thus, as early as 1965, considerable pressure was exerted on the fixed exchange rate system. By 1971, the U.S. gold stock had fallen to a post-war low, which prompted former President Nixon's decision of August 15, 1971 to close the U.S. gold window and

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suspend the convertibility of the dollar. This amounted to a de facto death of the Bretton Woods system.

The Fund was not even envolved in the major exchange rate decisions of the early 1970s. When President Nixon suspended the convertibility of the dollar in 1971, the then managing director of the Fund, Pierre-Paul Schweitzer, learned of Nixon's decision shortly before the President went on television to announce it.[35]

Two devaluations, a series of high level negotiations between the U.S and its allies, plus a jolt of U.S. economic nationalism failed to restore order to the international monetary system or the U.S. hegemony around which the Bretton Woods system was constructed. Finally, in 1973, the world's major industrialized nations adopted a system of floating exchange rates. When the developed countries decided to adopt floating rates, they reached this decision in private negotiations; they took major decisions that the Fund only ratified ex post.

When the fixed exchange rate system was abandoned, this diminished the Fund's role from what it had been under the old par value system. Since then, rampant instability has characterized the world foreign exchange markets and the Fund has been virtually powerless to prevent it. In recent years the Fund has been unable to persuade the major developed countries to refrain from manipulating the floating exchange rate system to wage concealed trade and exchange rate wars, a practice which directly contravenes Article IV of the Fund charter and the Second Amendment which prohibits "manipulating exchange rates or the international monetary system in order to gain an unfair competitive advantage over other members,..."[36] Competitive exchange rate depreciation violates the letter and the spirit

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of the Fund charter, and yet the United States pursued precisely such a policy from the middle of 1977 until the October 1978 crisis in the foreign exchange markets forced the Carter administration to reverse its policy. At the OECD meetings in June 1977, former Treasury Secretary Blumenthal began "talking down" the dollar in hopes of reversing the burgeoning U.S. trade and payments deficit. If the Fund was unhappy about this policy, it was much less successful than the foreign exchange markets in influencing the decision of the administration to change course. The Fund did provide resources to support the November 1, 1978 dollar defense program, but there is little evidence that the Fund convinced the Carter administration to intervene. Thus, while the Fund cannot be blamed for much of the recent instability in foreign exchange markets, there is little evidence that it exercises much control over them either.

When member countries--mainly LDCs--undertake stabilization programs which are financed from the upper tranches of the Fund, the Fund typically requires some form of exchange rate adjustment. However, the devaluations which the Fund frequently recommends for LDCs have only marginal effects on foreign exchange markets. The vast bulk of foreign exchange transactions take place in dollars, marks, yen, Swiss francs and a few other key currencies. In recent years, LDCs have increasingly influenced movements in foreign exchange markets, especially when central banks have diversified out of dollars into other hard currencies. However, the diversification of an LDC central bank's portfolio has nothing whatever to do with the devaluations mandated when countries undertake Fund stabilization programs.

The Fund does provide concessionary resources to member countries during periods of balance of payments difficulties. However, the level

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of the Fund's resources--and thus its ability to finance balance of payments disequilibria of member states--has fallen steadily since its inception. Recently, the Fund's resources, expressed as a percentage of world trade have fallen to an all-time low, as illustrated by the following table:

Fund Quotas as a Percentage of World Trade[37]

1945	16.2
1950	14.2
1960	11.5
1965	8.5
1971	8.2
1978	4.3

Moreover, Fund assistance is dispensed in such a way that perpetuates the basic asymmetry which characterizes the contemporary world economy. The Fund pays lip service to the question of promoting symmetry in the balance of payments adjustment process; in practice it concentrates its attention mainly on the deficit countries, especially the LDCs. This was amply illustrated during 1977 and 1978. Due to the declining value of the dollar, the real price of oil and OPEC's surpluses were actually shrinking. Yet at the same time, some of the industrialized countries, mainly Germany and Japan, ran up huge current account surpluses, whose counterparts were growing deficits in the LDCs. The combined current account surplus of the industrialized countries for the years 1977 and 1978 was approximately $37 billion, the oil-importing LDC countries recorded deficits equalling $52 billion.

During these two years, the Fund dished out a goodly number of stabilization programs designed to reduce LDC deficits, but failed to take any

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decisive action to reduce the German and Japanese surpluses. The deep asymmetry of the international monetary system was typified at the 1978 International Monetary Fund annual meetings by Germany's official position regarding its large current account surplus. Defending Germany against attacks on its surplus, the German finance minister replied: "An economy which for more than two decades became accustomed to produce external surpluses cannot easily adjust to current account disequilibrium. As everywhere, structural changes take time and organizational imagination."[38] That remark might have seemed a little hollow to some LDC officials who, when they approach the Fund for stand-by arrangements, are asked to undertake even more painful adjustments in no more than three years!

The Fund's overall contribution to economic growth and trade between the late 1940s and the early 1970s can be debated. There can be no doubt that since 1973 the Fund has been the major proponent of international deflation as the solution to global disequilibrium. Since the Fund has, or has sought, little influence over the policies of the big developed nations, it concentrates mainly on promoting deflation in the LDCs. Indeed, the Fund's role in the contemporary world economy is to compel deficit-ridden LDCs to retrench and thereby reduce their external deficits, at least temporarily. The main lever which the Fund uses to accomplish this is the conditionality which is attached to drawings from its upper credit tranches. The heavy bank lending to the non-oil LDCs after 1973 made the Fund a makeshift international lender of last resort to deficit countries. Otherwise, these countries would face default on loans to commercial banks and official creditors.

This is the sole area of current international monetary relations in

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which the Fund's role has expanded in recent years. It is also the area in which the Fund's power has been most counterproductive.

In all the other major areas of international economic policy, the Fund's role has actually diminished. In all candor it must be admitted that the actual role the IMF plays in the world economy is all out of proportion to the lofty principles expounded in the Fund charter. Major structural changes have occurred which have simply bypassed the Fund. More and more, the Fund has come to resemble a forum where monetary problems of great import are debated, but little action is taken. The IMF, according to a recent article in The Banker, now resembles a "talking shop." The characterization is apt:

> As the markets command so much more and as governments can vary their exchange rates at will, the IMF has recently not been able to do much more than tidy up after the market and act as a convenient buffer between the lending banks and their client governments. Of course the IMF is continuing to ease the path of certain individual problem countries; what it is not doing is managing an international monetary system.[39]

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The IMF, Private Banks and the LDCs

The IMF's involvement in formulating and monitoring stabilization programs in LDCs is nothing new. In the 1950s, the Fund established stand-by arrangements with a number of LDCs, especially in Latin America, and in the 1960s the rate of approval of these stand-by arrangements stepped up considerably. From 1953 to 1962 the Fund approved nearly 10 stand-by arrangements per year. This increased to roughly 22 stand-by arrangements per year for the years 1963 to 1972. The LDCs account for the vast majority of these stand-by arrangements.[40]

The use of Fund resources expanded considerably with the explosion of current account deficits in the non-oil LDCs after 1973. From 1974 to 1976, member countries drew unprecedented levels of Fund resources; however, they did so out of special or auxiliary facilities rather than the normal credit tranche facilities, especially the upper credit tranches. Most of the increase in Fund drawings came from the special Oil Facility. The shifting sources of drawings on the Fund is reflected in Table 1.

Paradoxically, after 1973 the number of Fund stand-by arrangements declined. In the period following 1973 the Fund approved fewer than 16 stand-by arrangements per year compared to 22 in the ten years prior to 1973. As the Dell report points out, "There were only five cases of drawings beyond the first credit tranche in the years 1974-76 among the entire Fund membership.[41]

Given the magnitude of economic disturbances in the years after 1973, the Fund's contributions (through its normal tranche facilities) to the balance of payments adjustment process in oil-importing LDC's was meager.

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USE OF FUND RESOURCES BY FACILITIES 1974-1979*

Type of Transaction	1974	1975	1976	1977	1978	1979
Total purchases	1,058	5,102	6,591	4,910	2,503	3,720
Reserve tranche	607	981	1,324	161	136	2,480
Credit tranche	239	1,604	461	2,370	1,937	485
Buffer stock	---	---	5	---	---	48
Compensatory financing	212	18	828	1,753	322	465
Extended facility	---	---	8	190	109	242
Oil facility	---	2,499	3,966	437	---	---

* Financial year ended April 30.

Source: Annual Report 1979 (Washington, D.C.: International Monetary Fund), p. 72.

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in the tranches, the weaker industrialized countries consumed most of the resources. In 1975, for example, more than SDR 1.6 billion was purchased under the Fund's credit tranche facilities; however, Italy accounted for approximately 1.2 billion of this total.[42] Total use of Fund resources declined dramatically in 1976 but rose again to a record SDR 2.37 billion in fiscal year 1977. In 1977 all but SDR 500 million tranche purchases were made by Britain. In fact during the fiscal year 1976-77 the Fund approved a total of 19 stand-by arrangements totalling SDR 4.68 billion but about 80% of this represented stand-by arrangements with Britain and Italy.[43] In 1978, as the LDCs' current account deficits rose dramatically, most of the purchases of the Fund's resources were made not by these countries, but by the United States. In late 1978 the United States purchased SDR 2.2 billion from the Fund's resources as part of the November 1 dollar rescue program. This represented approximately two-thirds of the use of Fund resources during the entire year of 1978.

Why have the LDCs been reluctant to undertake Fund stand-by arrangements? The greatest single cause for the decline in the number of stand-by arrangements in the 1970s, and the absolute decline in the use of Fund resources after 1976, is the conditionality which the IMF attaches to drawings from its upper credit tranches. The conditionality represents a strong deterrent for member countries to enter into Fund stabilization programs requiring upper credit tranche borrowing. Once the Oil Facility was eliminated after 1976, the use of Fund resources declined markedly, even though the non-oil LDCs continued to register large current account deficits in 1977 and 1978.

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A country experiencing a balance of payments deficit may have several options. One is to seek concessional bilateral or multilateral assistance which may partially or fully finance the gap between export revenues and import demand. Secondly, a number of countries may go to private international capital markets, especially the Eurocurrency and Eurobond markets, in order to finance their deficits. In recent years as spreads over the LIBOR (London Inter Bank Offer Rate) have narrowed appreciably for some borrowers, the LDCs have actually had a strong incentive to borrow from private sources than from the Fund. Significantly, a number of countries have in fact borrowed heavily in private markets at market interest rates and by-passed the Fund's concessional resources in order to avoid its conditionality. The tendency has not been confined to any single type of government or ideological persuasion. The LDCs simply view the Fund as something to be avoided until all other sources of international credit have been exhausted. This was recognized by Arthur Burns, former Chairman of the U.S. Federal Reserve Bank:

> One reason why countries often are unwilling to submit to conditions imposed by the IMF is that the amount of credit available to them through the Fund's regular channels is in many instances small relative to their structural payments imbalance. That will be so even after the scheduled increase in IMF quotas becomes effective.[44]

Given the decline in LDC utilization of Fund resources, what is the source of the IMF's growing power in the economic affairs of the LDCs? Since the Fund really has no lever of power other than the conditionality which is attached to its upper credit tranche drawings, how can we substantiate the claim that the Fund's power over LDCs is growing at a time when the actual number of stand-by arrangements which LDCs undertake is declining?

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The source of the IMF's power does not derive from the amount of balance of payments financing it dispenses. Expressed as a percentage of world trade, the Fund's resources have been shrinking since its inception. Rather, the source of the IMF's power in the contemporary world economy lies in its unique relationship with the big commercial banks.

Most banks began to lend heavily to LDCs in the 1970s, especially after 1973. Banks did not pay particularly close attention to the creditworthiness of their new customers when they loaned petrodollars. Thus, many poor countries borrowed to maintain economic growth rates and living standards in the face of tremendous external pressures. Countries borrowed to finance consumption and investments that would not generate new export earnings or reduce imports for many years. As the debts accumulated, countries encountered foreign debt obligations which they could not meet on time.

Historically, major debt rescheduling by Western governments has provided a convenient means of avoiding default. However, the sheer increase in the number of countries in trouble, plus the increasingly private character of the debt, made this procedure inadequate.

The IMF was called upon to provide an institutional framework to manage the enormous instability they engendered. Private banks, in the words of Irving Friedman, came to view the Fund as a "Fire Department" to cope with potential financial disasters. As more countries like Zaire, Peru, Turkey, Jamaica and the Sudan became over-extended, private banks looked to the Fund to certify their creditworthiness before rescheduling old loans or extending new ones.

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The dialectic of Fund-bank relations transformed the role of Fund stand-by arrangements. Initially, the Fund established the stand-by arrangement to meet the balance of payments financing needs of member countries. Now the stand-by arrangement serves the broader function of opening the door to private financing.[45] For countries in shaky financial condition, concluding an agreement with the Fund on a stabilization program is frequently a prerequisite to obtain private refinancing or new borrowing.

For the private banks there are distinct advantages to letting the Fund make judgments on the creditworthiness of a country and then following its lead. The Fund has a certain legitimacy as a multilateral institution and access to delicate governmental information. Unlike most banks, the Fund employs a large staff of professional economists with considerable experience in dealing with LDCs, whereas most banks became large lenders to LDCs only after 1973.

The Fund and the banks share certain objectives. The banks want to be repaid while the Fund's role is to ensure the smooth functioning of international trade and financial flows. To be effective, Fund stabilization programs frequently require stretching out debt payments. Frequently the Fund must buy time for countries by persuading banks to reschedule large amounts of private debt. Just as the banks turned increasingly to the Fund to certify a nation's creditworthiness, so the Fund needed the banks to approve reschedulings in order to provide time for countries to adjust and replenish depleted foreign exchange reserves.

This was not a planned affair, but rather a marriage of convenience. Initially the banks were unwilling to cede more authority to the Fund and tried to go it alone in refinancing the debts of borrowers in danger

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of default. The test case was Peru. Peru's debt crisis of 1976 was, according to both high Fund and private bank officials, a "watershed" in relations between private banks and the IMF. In 1976, Citibank headed a major rescheduling operation for the government of Peru, which turned into a fiasco. The operation was engineered by Irving Friedman, a former Fund and World Bank official, who has become the chief troubleshooter in many reschedulings, not just for Citibank but for many banks who participate with Citibank in syndicated Eurocurrency loans to LDCs. The Peruvian case was a turning point in relations between private banks and the Fund because the failure of the private financing of Peru's debts convinced the banks that the Fund was better suited to sponsor extended adjustment programs.

Peru was a particularly controversial case. Following the coup of 1968, multilateral and bilateral aid agencies grew suspicious of General Juan Velasco Alvarez's left-leaning military regime, but commercial banks poured money into his projects. The Velasco regime increased Peru's external public debt dramatically, from roughly $1 billion in 1968 to $4.4 billion by 1975.[46] The banks were convinced that high copper prices would provide Peru with stable export income, while new oil discoveries were expected to produce a future bonanza. By early 1976, these expectations proved overly optimistic and Peru was nearly bankrupt.

Peru needed help, but the government wanted to avoid strict IMF conditionality. So President Francisco Morales Bermudez approached Peru's private creditors for a rescheduling arrangement. In July 1976, six banks --Citibank, Chase Manhattan, Wells Fargo, Bank of America, Morgan Guaranty, and Manufacturers Hanover--concluded a mutually acceptable refinancing

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with Peru. The banks preferred this course to a default which, they felt, might lead to Bermudez's replacement by a more radical regime.[47] These banks granted Peru an additional $250 million of new financing, contingent upon the government's raising another $100 million from European, Japanese, and Canadian banks. The government also had to accept the following conditions:

--macroeconomic stabilization measures; including a 44% devaluation of the sol, price increases, and budget cuts;

--a more conciliatory attitude toward foreign investment; demonstrated by reopening the jungle and coastline to private oil and reaching an accord on compensation of the Marcona Corporation for the iron mines nationalized in 1975;

--encouragement of local private ownership by reducing the "social property" sector of the economy.

The banks found it difficult to force Peru to comply with these conditions. First of all, Peruvian officials disagreed on the program, which made it impossible to submit a workable budget. Secondly, the banks did not have access to confidential government financial data. Other information on economic and financial trends was inadequate. Since banks are ill-equipped to gather such data, they found it difficult to judge the likely long-term effect of the stabilization measures.

By mid-1977 the banks' inability to monitor the agreement forced them to abandon it. Peru's economic crisis worsened and default again loomed on the horizon. This time the banks looked to the IMF to bail them out. The banks demanded that Peru reach an agreement with the IMF, which they decided was more equipped to enforce a stabilization program. In November 1977, the IMF handed Peru a stand-by which the Finance Minister

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and President of the Central Bank signed "without reading it."[48] In February 1978, however, the IMF declared Peru in violation of the conditions of the arrangement and the whole thing was off. The program failed because the targets which the Fund expected Peru to meet were so unrealistic that they threatened to ignite a civil war or revolution had the government complied with them.

At that point relations between Peru and the IMF reached their nadir. In effect, Peru was in default with the commercial banks. The Peruvian government almost declared Linda Koenig, the IMF's country economist for Peru, persona non grata in Peru, and the government demanded that a senior official renegotiate the program with Peruvian officials.

The next time E. Walter Robichek, head of the Western Hemisphere Division, returned to negotiate a new agreement. After months of negotiations, the IMF and Peru finally reached an agreement in August 1978 giving Peru access to SDR 184 million over a two-year period. With Peru back in the Fund's good graces, the banks were ready to talk about refinancing. The reason: with access to the Fund's resources, Peru would now have the cash to pay off some of their pressing private bank debts. More importantly, its economic policies would be under strict scrutiny by the Fund.

On January 3, 1979, a consortium of 280 banks headed by Manufacturers Hanover Trust Co. approved a refinancing agreement with Peru for roughly $2 billion of notes and credits due through 1980.[49] The text of the refinancing arrangement with Peru reveals how private multinational banks take advantage of the power of the Fund to provide a safety net for their operations in the LDCs. The carefully worded agreement stipulates that the refinancing is tied directly to the government's compliance with the specific

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performance targets of the IMF agreement and hence the government's ability to draw SDR 184 million from the Fund. Peru not only must meet the targets established under the stand-by to the satisfaction of the Fund, the agreement stipulates that "such limits and targets shall be satisfactory" to the banks. This, of course, means the banks passed judgment on the targets of the Fund stand-by before Peru signed the agreement. More importantly, the agreement between the banks and Peru stipulates that the entire refinancing arrangement will be terminated if, among other things:

(1) Peru ceases to be a member of the IMF:

(2) Peru is no longer able to draw funds under the terms of the August 1978 stand-by;

(3) the Fund or any other official creditor demands repayment ahead of the banks, thereby altering the repayment schedule

(4) the Peruvian authorities refuse to turn over normally confidential communications between the government and the Fund.

If any of these conditions are not met, the outstanding loans are automatically called in and Peru will be saddled with a huge backlog of debts.

The banks' sour experience with Peru in 1976 thus resulted in a permanent bond with the IMF. Today, Irving Friedman's view is somewhat different than in 1976. Then he had been willing to sponsor private debt renegotiations independent of the International Monetary Fund. Recently, however, he has written:

> If the Fund will not certify the good efforts of a country in difficulties, banks can be expected to take whatever defensive measures, if any, they deem advisable and feasible. Countries in difficulty are well aware when this happens. The influence of banks on stabilization programs stems primarily from the fact that new lending by the banks will not be resumed in substantial amounts until the country's economic management performance meets the country creditworthiness criteria of the lending banks.[50]

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Moreover, private banks do not flinch from demanding that when a country repays its overdue obligations, the banks' loans be given top priority. In Friedman's words:

> Private banks are likely to insist on performance of debt servicing obligations to them being given the highest payments priorities by borrowers. They cannot give "debt relief" for political reasons. Public agencies...have an option to act more leniently. This is, in effect, a political decision that should be kept separate from private bank decisions.[51]

The Peruvian experience has formed the basis for a continued relationship between the IMF and the private banks. In most cases, the Fund will take responsibility for drawing up the agreement, monitor the country's compliance and bear the adverse political publicity associated with tough stand-by programs. The banks' exposure is covered because debtor governments know that if they violate the essentials of the stand-by agreement they will find themselves closed out of the world's capital markets.

Ironically, Walter Robichek himself has pointed out that the very structure of the syndicated Eurocurrency loan market has "some of the attributes of a cartel..."[52] If this was true of the syndicated Eurocurrency loan market before 1976, how much more convenient things are for the cartel now with the raw power of the International Monetary Fund behind it!

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The Nature of Conditionality

The central issue in the debate over the future of the International Monetary Fund is the nature of Fund conditionality and its impact on member countries. Fund conditionality, which has become increasingly rigid in recent years, has become the main deterrent to the use of Fund resources. Not coincidentally, Fund conditionality tightened as the LDCs became the principal borrowers in the 1950s and 1960s. Today, the Fund's unique role vis a vis the private banks, plus the tightening of the conditionality attached to its upper tranche drawings, has made the Fund a powerful supranational lender of last resort for debt-ridden LDCs.

Fund stabilization programs differ depending upon the country concerned and the nature of its balance of payments problems. However, the Fund has a standard approach, or world-view, upon which all stabilization programs are based. Stabilization programs are based on the monetarist model developed at the Fund by J. J. Polak and others. The model was explicitly developed as a counterweight to the Keynesian income analysis which dominated the early post-war period. However there are some analytical aspects and policy conclusions upon which the Keynesians and monetarists would agree.

The Polak framework is monetarist in the sense that changes in the supply of money are held to be the principal determinant to changes in income, prices and the trade balance. If the supply of money or credit creation (or inflow of foreign exchange) increases at a rate which exceeds the real rate of growth of the economy, inflation will result. Higher nominal incomes will increase demand for imports, thereby plunging the economy into a trade deficit. Eventually, unless the excess money

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creation is corrected or a devaluation is undertaken, the inflation will undermine the country's international competitiveness and cut into exports. Thus the Fund's model of how disequilibrium occurs in the balance of payments is based on the apparent proclivity of governments to expand the supply of money and credit--which inflates the price level--provoking internal distortions in the allocation of resources and inhibiting a country's international competitiveness.

However simplified this description of the Fund's stabilization model is, it illustrates a unifying feature which runs like a red thread throughout most Fund stabilization programs: the assumption that the sources of economic disorder and the remedies for it lie at the domestic policy level. This is assumed to be as true in the LDCs as it is in the developed economies. Thus the Polak approach concludes that equilibrium in the balance of payments of LDCs can be corrected if only governments would adopt the correct policies. In the Fund's view, the policy changes revolve around tampering with the exchange rate in order to restore equilibrium prices and wages and reducing the supply of credit, especially to the public sector.

It should be noted that the Fund's analysis of balance of payments problems has been modified to some extent in recent years. Formerly it was a tenet of orthodox economic theory that balance of payments disequilibria were normally short-lived and self-correcting.[53] In fact, in the Fund's Articles of Agreement, the Fund pledges to "give confidence to members by making the resources of the Fund temporarily available to them." Thus the founders of the Fund viewed its resources as a kind of cushion

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to tide member countries over when they experience temporary balance of payments deficits.

In recent times, however, this premise became increasingly at odds with reality. Many LDCs have endured chronic balance of payments crises throughout the post-war period which were obviously not of a self-correcting nature.

The Fund finds the simplicity of the monetarist approach appealing as a guide to formulating stabilization programs, but that is also its fundamental limitation. As a guide to stabilization policy, especially in LDCs, the basic flaw is reducing the enormously complex relations which characterize the contemporary international economy to a couple of simple propositions regarding the stock of money and the price level. In reality, a variety of forces, both real and monetary, determine the supply of credit in an economy, let alone the trade balance.

This is not the place to elaborate on the old debate between the "structuralists" and "monetarists" on the ultimate causes of balance of payments deficits in underdeveloped economies. Suffice it to say, as Alejandro Foxley has pointed out, that the resurgence of monetarism in the 1970s overlooks a wealth of experience gathered throughout the post-war period showing that the monetarist toolkit is not only inadequate to the specific features of balance of payments disequilibria in LDCs, but its application entails horrendous social and economic costs.[54] In the 1950s, the IMF's approach to balance of payments deficits was characteristically monetarist. It was thought that reducing the role of the state in the economy and expanding the supply of money in concert with the long-term growth trends in an economy would stimulate growth and development

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which would wipe out the causes of the trade deficit. That these measures did not provide a permanent solution to balance of payments problems, inflation or supply problems is evidenced by the high rate of recidivism among countries who have tried the orthodox monetarist approach. Many countries in Latin America, including Peru, Colombia, Argentina, Bolivia and others have had a dozen or more stabilization programs. Yet their fundamental problems have not been overcome.

In some countries the inequities generated by the application of strict market solutions have led to political pressure for radical redistributive policies, which have ended in authoritarian military take-overs to restore the status quo. In this sense Foxley argues we have come "full circle" in the debate over appropriate stabilization measures. The inequities and stagnation generated by the monetarist policies precipitated widespread popular dissatisfaction and led to the application of structural policies designed to change the entire economic structure of a society. Frequently, these policies led to more inflation and external difficulties which, in the 1970s, precipitated a return to the monetarist policies of the 1950s.[55]

It is ironical that the cataclysmic events of the 1970s which gave the Fund its enormous clout with LDCs also rendered its stabilization programs even more removed from economic realities. After 1973, the particular structural vulnerability to external crises that plagues most underdeveloped economies led to massive current account deficits which could be neither financed nor ignored. Their resistance to standard macroeconomic stabilization measures also bankrupted the Fund's stabilization model and policies. Internal factors played a secondary role in

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generating disequilibria in most countries. In the words of Sidney Dell:

> The primary factors in balance of payments deficits were not...associated with excessive pressure of domestic demand. While elements of demand pressure were still to be found, the more characteristic experience was cost inflation resulting at least in part from soaring import prices--accompanied by real demand deflation. Balance of payments deficits were not generally due to substantially expanded import volumes but rather to increases in the general level of prices and deterioration in the terms of trade--circumstances for which the developing countries in deficit were not responsible.[56]

The main external sources of disequilibrium cited by Dell were:

> --The sharp changes in the prices of primary commodities, expecially in 1974-75, and the acceleration of the upward trend in prices of manufactured goods imported by developing countries.
>
> --That part of developing country deficits that constituted the counterpart of structural surpluses in certain industrial and certain oil-exporting countries.
>
> --The shifting of balance of payments pressures from industrial countries to developing countries through the slackening of import demand in the former countries associated with the recession of 1974-75 and the period of low growth that ensued.
>
> --The further shifting of pressures resulting from a growing wave of protectionism in the industrial countries directed particularly at imports from low income countries.[57]

The specific disorders of the 1973-75 period were an expression of the more general failure of market forces alone to generate self-sustaining development in the LDCs and which would allow them to adapt more easily to external economic fluctuations. IMF programs neglect the fact that in many countries improving the trade balance requires structural change which can be achieved only in the process of genuine development. Instead, the Fund takes the existing structures for granted and tries to force-feed the economies into adjustment programs which cannot bring about this

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structural transformation.[58] As one IMF country economist told me recently, "Look, I don't know much about international monetary reform issues, I'm just trying to devise a financial stabilization program for one country".

The Fund's incorrect analysis of the source and nature of balance of payments deficits in the LDCs seriously impairs its ability to devise workable stabilization programs. This is why the Fund's programs are increasingly ineffective, even on their own terms. The inadequacy of Fund stabilization programs to achieve their objectives is demonstrated in the Fund's own analyses of recent stabilization programs. In a review of 21 stand-by arrangements in 18 countries during the 1973-75 period, T.R. Reichmann compares the aims of the stabilization programs with their actual results. Reichmann's results show only a 33% success rate for these 21 Fund stabilization programs. He credits exogenous factors with the successes as well as the failures. He concluded that:

> ...the magnitude of the balance of payments disturbances and the existence of strong external factors seriously affected the design and implementation of the programs. As a result, of the 21 programs under review, only 7 are considered successful, and even then only with some qualifications.[59]

Reichmann determined that in 14 of the 21 stand-by arrangements the country's balance of payments position improved but he stresses that the improvement resulted from factors independent of the stabilization program.

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> Even in cases where the balance of payments target was achieved or over-achieved, only 3 countries had put into effect adequate domestic policies. In the remaining 11 (successful) cases, the improvement in the balance of payments was associated with a temporary increase in exports, heavy restrictions on international transactions, or large inflows of short-term capital.[60]

It is significant that an earlier analysis by Reichmann and Stillson suggested a higher rate of success for stabilization programs on balance of payments and other criteria.[61] Of 79 selected cases between 1963 and 1972 Reichmann and Stillson found that 76% of the stabilization programs had achieved their primary goals. What the Fund's own analysis suggests, therefore, is that IMF stabilization programs were less effective after 1973 than before in achieving their own objectives. Reichmann attributes the decreasing success of Fund stabilization programs to the increasing importance of exogenous factors in creating payments imbalances during the post-1973 period.[62] In other words, because the sources of disequilibrium were more frequently external in origin after 1973, then, understandably, internal policy adjustments should have proved less effective in solving balance of payments problems. Reichmann's analysis confirms this hypothesis.

Despite the declining rate of success of Fund programs in restoring even temporary equilibrium in the balance of payments, the Fund considers this the <u>easiest</u> of objectives to attain through the stabilization programs. The Fund admits that other longer-term goals, which include restoring price stability and stimulating economic growth -- i.e. avoiding stagflation -- are even less likely to be realized. In fact, the exigencies of Fund programs, especially devaluation and tightening credit themselves

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make it more difficult to attain these other objectives. The confidential staff appraisal of Peru's recent two-year stand-by arrangement is remarkably candid on this point.

> With full observance of this program, the restoration of balance of payments equilibrium is apt to be the objective of the Peruvian authorities that will prove the easiest to attain. The deceleration of inflation is likely to be a more elusive objective, mainly because the requisite price, wage, exchange, and interest rate adjustments are bound to impart new inflationary impulses. Of the three declared objectives of the program, the one whose early attainment is most in doubt is a revival of production. It is most regrettable that the sacrifices which the combination of contemplated policies is bound to exact from the Peruvian public is not likely to be rewarded quickly by a resumption of economic growth.

This prediction is substantiated in a recent paper by William R. Cline of the Brookings Institution, who is not particularly critical of the Fund stabilization program.[63] Manuel Moreyra, the president of the Central Bank, puts it this way: "The Fund is absolutely terrified. The way the stand-by is drawn up we could have an inflation of 300 per cent and still be sticking religiously to their targets".[64]

The Fund's short-sighted preoccupation with achieving temporary equilibrium in the balance of payments is also evident in the recent stabilization program in Peru. The program, which exacted heavy sacrifices from the Peruvian people, appears to have been unnecessarily harsh.

Peru's economic prospects are brighter today than when the government adopted the Fund stabilization program, but the program had only marginal effects, if any, on Peru's recovery. In 1979, windfall gains from both copper and oil exports increased Peru's export earnings considerably. This has allowed Peru to repay some of its foreign debts earlier than expected. Yet it taxes the imagination to understand how the devaluation

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and credit tightening which Peru undertook at the behest of the Fund contributed to higher oil and copper prices. In fact, the substantial inflow of foreign exchange has created the opposite problem: how to keep inflation from getting out of hand. Thus Peru undertook a stabilization program which even its defenders claim had considerable social and human costs and turned out to be inconsequential to the country's recovery.

If the Fund's recent stabilization program for Peru revealed the institution's shortsightedness, the 1979 program which the Fund granted to the Somoza government of Nicaragua suggests that the Fund's management is unaware that major political developments can impede the effectiveness of its neat economic models. Two months before the overthrow of the tyrannical Somoza government, the IMF's Board of Directors approved an 18-month stand-by arrangement with Nicaragua thereby allowing the government to purchase SDR 34 million. In the confidential staff recommendation accompanying the stand-by arrangement, the Fund staff noted that the program carried "substantial risks", yet considered the details of the program "technically sound". The program was approved on May 14 and on July 19 the Somoza regime was overthrown. The question is not whether the Fund should permit shaky governments to enter into stabilization programs, but how a competent staff could consider a program "technically sound" which fails to take account of the economic effects of a civil war.

Long before his guerilla opponents captured Managua, the local elite who had benefited from decades of Somoza family rule deserted the dictator. The country was beset by massive capital flight and the government had totally lost its legitimacy. Yet the Fund program for Nicaragua contained such measures as an incomes policy and improvement in the central government's

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revenues. In other words, a government despised by most of the population not only had to reschedule its foreign debt, but raise additional taxes, stem capital flight and control the growth of wages.

One Latin American central bank chairman called the stabilization program for Nicaragua "the ultimate farce of the Fund. Can you imagine putting through a typical fund program -- pretty awful in the best of times -- in the middle of a civil war?" Referring to the text of the stabilization arrangement which read: "The cornerstone of the financial program of the Nicaraguan government is a very large improvement in the financial position of the public sector," he said, "is that nonsense or is that nonsense?"[65]

Fund stabilization programs are not only increasingly removed from political and economic realities, they are also fundamentally regressive. The very nature of Fund stabilization programs, especially those in LDCs, tends to throw a disproportionate share of the burden of adjustment on those least able to bear it. These programs frequently exact heavy sacrifices from the poor, workers and parts of the middle class; sacrifices which would be politically intolerable in our own country. For this reason, Fund stabilization programs are frequently better suited to authoritarian countries than to more democratic ones. The programs are not, as the Fund charter suggests, supportive of national prosperity; they precipitate austerity and national retrenchment. Even governments which would do so find that Fund programs make it impossible to meet the basic human needs of their citizens.

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For example, the Manley government of Jamaica and the IMF staff have recently reached an impasse in their renegotiation of Jamaica's three-year stabilization program. In recent years, Jamaica has been wracked by the same succession of economic disturbances which have burdened most oil-importing LDCs. These difficulties were exacerbated by a U.S. aid embargo and a fall in tourism receipts during the Ford administration. In addition, the Manley government's pursuit of social and economic reforms has resulted in a debilitating "brain drain".

In May 1978, Jamaica entered into an Extended Fund Facility and qualified for a Supplementary Financing Facility in 1979. Recently, however, higher interest rates and rising prices of other imports have caused Jamaica to exceed both its fiscal and external deficits targets by J$100 million each. In 1980, Jamaica will earn approximately $672 million in export revenues. Yet, to pay for the costs of imported oil and service its external debt, Jamaica will spend $691 million. Fifty-four percent of Jamaica's export earnings now go to service its external debt.

Negotiations between the Fund and Jamaica have broken down because the Fund has requested budget cuts of more than J$100 million. Jamaica, a country plagued by unemployment and poverty, estimates that the cuts the Fund is asking for would translate into the loss of thousands of jobs and lower real incomes. During the first year of the Extended Fund Facility, the World Bank estimates that the real wages of Jamaican workers fell by more than 25% and perhaps as much as one-third. Real per capita consumption fell by 13% in 1978.[66] As in the case of Peru, the Fund program has not generated real economic growth or the expansion of employment. Unemployment still victimizes more than 25% of the labor force. How can Jamaica be asked to continually tighten its belt to satisfy the IMF's conditionality when there are no more belt holes left to tighten?

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CONCLUSIONS

Mr. Chairman, the administration has urged passage of H.R. 5970 for three main reasons. One, the administration maintains that expansion of the U.S. quota in the Fund "will help assure that the IMF can continue to meet its responsibilities for international monetary stability." Secondly, the administration believes that larger Fund quotas will "provide additional resources to encourage cooperative balance of payments adjustment policies." Finally, the administration suggests that an expansion of the U.S. quota will "maintain our financial rights and our voting share...at a time when far-reaching changes in the monetary system...may be under consideration."

Mr. Chairman, I cannot accept the administration's assessment that the IMF's record is "a good one in adapting to changing world circumstances and responding to the needs of its members." In my testimony, I have outlined the three main sources of present international monetary instability: the decline of the dollar as the world's key reserve currency; the tremendous expansion of the unregulated Eurodollar market and the accumulation of massive indebtedness in the oil-importing LDCs. At present, the IMF is not dealing effectively with any of these. I have no way of predicting whether or not the creation of a substitution in the IMF will relieve some of the pressure on the dollar. Both technical and political differences regarding the financing of the substition account have yet to be resolved. If the objective of the substitution account is to reduce some of the dollar overhang, then perhaps it can have an effect. The dollar overhang continues to be a major source of monetary instability and inflation. If the dollar overhang can be reduced, then perhaps some progress can be made in these areas. However, the IMF's record in this regard is not a good one, as witnessed by

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the recurrent global monetary instability we have experienced since the decline of the Bretton Woods system. In any case, I believe that we would have to supplement the substitution account with reserve requirements on Euromarket activities, in coordination with foreign central banks.

The administration's view is that larger Fund quotas will promote a more cooperative balance of payments adjustment policies. Yet we have seen that the Fund has not promoted such a process with its existing resources. Therefore, are we to assume that a mere quantitative change in the level of the Fund resources will promote a more cooperative balance of payments adjustment process? Mr. Chairman, I believe the answer is most emphatically no. The Fund uses only a small proportion of its existing resources now and member countries are extremely reluctant to undertake stabilization programs in the upper credit tranches of the Fund because of the burden of conditionality. Relative to many countries' balance of payments needs, a small proportional increase in the level of Fund resources will not transform members' attitudes concerning the Fund.

Mr. Chairman, no one would argue that the Fund should simply give away resources to any sovereign state without some form of conditionality. However, the kind of conditionality the Fund now imposes on member countries clearly is not solving their balance of payments problems, their inflation problems or their growth and investment problems. These problems are reflections of deep structural problems in the contemporary world economy. Growth rates are slower today than they were ten or twenty years ago, trade is growing more slowly, price stability remains an elusive goal, unemployment and underutilization of resources exist on a wider scale than many economists are willing to admit. The present form of Fund conditionality

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has not baen modified significantly in recent years. Take for example, the so-called reform guidelines issued in March 1979. These guidelines indicate that the Fund will take into account the "domestic social and political objectives" of member countries in formulating stabilization programs. This change of rhetoric no doubt reflects the increasing criticism of the Fund's stabilization programs. Yet it is unclear how these guidelines affect the design and implementation of Fund stabilization programs, if at all.

Mr. Chairman, before voting favorably on the issue of increasing the U.S. quota in the Fund, I urge the members of this committee to scrutinize the close relationship that exists between the commercial banks and the IMF. It is significant that while bankers typically oppose governmental interference with market mechanisms, they have not hesitated to hide behind the skirts of a publicly funded international institution when loans they have made to individual countries are threatened with default. It is a legitimate question whether the taxpayers' money should be funneled to the LDCs via the IMF to compensate Citibank and Chase Manhattan for imprudent loans they have made.

Mr. Chairman, I believe that the administration is being less than candid about much of the motivation behind the new quota increase. We are witnessing an increasing unwillingness on the part of the private banks to facilitate a new round of petrodollar recycling. Is the real purpose of the new quota increase to create a safety net under the operations of private banks in the LDCs?

Mr. Chairman, I would support this increase in the U.S. quota in the Fund if I could be assured that it was not simply an expedient to protect

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the banks from defaults, while the Fund's programs grind down the poor and oppressed citizens of the world's poor countries. We have not received such assurances from the administration. I hope the Congress will amend this legislation to speak to these concerns.

Finally, Mr. Chairman, let me say that I think the International Monetary Fund is becoming increasingly obsolete as the central monetary institution of the world economy. The Fund has certainly lost its legitimacy among many LDCs and I believe it is also increasingly inadequate to promote the interests of the industrialized world in a stable monetary order. Sooner or later we must go beyond simple palliatives and begin to negotiate a genuine new international monetary order. I can only urge that this process begin sooner rather than later.

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FOOTNOTES

1. See, for example, the Financial Times, October 31, 1978, p.1.

2. Federal Reserve Bank of New York, Annual Report, 1978, p. 19.

3. Business Week, March 12, 1979, p. 70.

4. Ibid.

5. Rooert Triffin, "The International Role and Fate of the Dollar", Foreign Affairs, Winter 1978-79.

6. Testimony of the Hon. Henry C. Wallich, Member of the Board of Governors of the Federal Reserve System, before the Subcommittee on International Trade, Investment and Monetary Policy and the Subcommittee of Domestic Monetary Policy of the House Committee on Banking, Finance and Urban Affairs, July 12, 1979; reprinted in, The Eurocurrency Market Control Act of 1979, (Washington, D.C.: Government Printing Office, 1979.)

7. Estimate prepared by Shearman & Sterling, the New York law firm retained by Citibank to investigate allegations made by David Edwards, a former Citibank employee in Paris, who was fired by the bank after charging that Citibank's intra-firm foreign exchange transactions violated numerous tax and exchange control laws.

8. As Under Secretary of State Richard Cooper has pointed out, "The big change, I think, that has taken place over the last 20 years is in both the technical facilities and the education, or consciousness,...regarding movement of funds across national boundaries. If there is money to be made, or it is thought there is money to be made by moving assets from one currency to another, that is as true for Americans living in New York, or Chicago, or San Francisco as it is for holders of dollars in London, and Zurich and Singapore." Richard N. Cooper, in his appearance before the Subcommittee on International Economic Policy, of the Senate Committee on Foreign Relations, May 24, 1979.

9. Calculated from annual reports. For a discussion of Dow Chemical foreign exchange operations, see Laura White Dillon, "Dow's Controversial Currency Strategy", Institutional Investor, July, 1979.

10. IMF Survey, November 26, 1979.

11. Tesimony of the Hon. Henry C. Wallich, July 12, 1979, op. cit.

12. Business Week, August 6, 1979, p. 16.

13. Richard J. Barnet and Ronald E. Muller, Global Reach: The Power of the Multinational Corporations (New York: Simon & Schuster, 1975), pp.284-5.

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14. The Wall Street Journal, October 19, 1979, p. 37. The information reported in this article was subsequently confirmed by the public information office of the New York Federal Reserve Bank.

15. Citicorp Annual Report, 1978. The best available discussion of the internationalization of the U.S. banking system is Committee on Banking Currency and Housing, U.S. House of Representatives, Financial Institutions and the Nation's Economy, Part 4 (Washington: Government Printing Office, June 1976).

16. Irving S. Friedman, The Role of Private Banks in Stabilization Programs, September 8, 1979; and his remarks at a conference on "Stabilization Programs in Less Developed Countries", sponsored by the Brookings Institution, October 25-26, 1979.

17. E. Walter Robichek, "Some Reflections About External Debt Management", International Monetary Fund, December 1979.

18. Friedman, op. cit.

19. Business Week, November 19, 1979 and IMF sources.

20. Bank for International Settlements, figures quoted in the IMF Survey, November 26, 1979, p. 371.

21. Journal of Commerce, January 11, 1980.

22. International Herald Tribune, November 27, 1979, p. 85.

23. Institutional Investor, September 1979, p. 103. Wall Street Journal, February 4, 1980, p. 1. Business Week, November 19, 1979.

24. National Advisory Council on International Monetary and Financial Policies, Special Report to the President and to the Congress on Proposed Increases in Quotas of the International Monetary Fund, November 1979, p. 1.

25. U.S. Treasury Department, "The Operation of the International Monetary System, July 1977 - March 1979: A Treasury Reassessment", July 11, 1979.

26. Articles of Agreement (Washington, D.C.: International Monetary Fund, 1973), p.2.

27. Thomas Balogh, Fact and Fancy in International Economic Relations, Elmsford, N.Y.: Pergammon Press, Inc., 1973).

28. Fred Block, The Origins of International Economic Disorder (Berkeley: University of California Press, 1977), p. 112.

29. Ibid., Chapter 5.

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30. International Monetary Fund, Annual Report, 1979, p. 13.

31. Overseas Development Council, The U.S. and World Development: Agenda 1977, (New York: Praiger, 1977), p. 208. For a full discussion, see Hans Singer and Javed Arsair, Rich and Poor Countries, (London: Allen & Unwin, 1977).

32. Rex Bosson and Benslon Varon, The Mining Industry and the Developing Countries (Washington, D.C.: Oxford University Press, published for the World Bank, 1977).

33. Charles R. Frank, Jr., Debt and Terms of Debt, Overseas Development Council Monograph Number One (Washington, D.C.: ODC, 1970).

34. International Monetary Fund, Articles of Agreement, Op. Cit.

35. Susan Strange, International Monetary Relations, Vol. 2 of International Economic Relations of the Western World 1959-1971, edited by Andrew Shonfield (London: Oxford Univeristy Press, 1976), p. 338.

36. International Monetary Fund, Proposed Second Amendment (Washington, D.C.: International Monetary Fund, 1976), p. 257.

37. IMF Annual Report, International Financial Statistics, various issues, UN Yearbook of International Trade, various issues.

38. Quoted in Sidney Dell, et. al., The Balance of Payments Adjustment Process in Developing Countries: Report to the Group of Twenty-four, UNDP/UNCTAD (New York: United Nations, 1979).

39. "What the BIS Stands For", The Banker, June 1979.

40. IMF, Annual Report 1979, p. 111.

41. Sidney Dell, Op. Cit., p. 9.

42. IMF, Annual Report 1975, Appendix 1.

43. IMF, Annual Report 1977, p. 52.

44. Arthur Burns, Euromoney, October 1977.

45. As Gabriel Hauge, former chairman of Manufactuers Hanover Trust Company points out, "Commercial banks tend to feel more at ease with their country credits after the IMF has stepped in and...established a viable adjustment program." Euromoney, October 1977.

46. World Bank figures quoted by Barbara Stallings, "Peru and the U.S. Banks: Privatization of Financial Relations" in Richard Fagen, Ed., Capitalism and the State in U.S.-Latin American Relations, Stanford University Press, 1979, p. 235.

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48. Nicholas Ashekov, "Peru Hits the Comeback Trail," Institutional Investor, July 1979.

49. Agreement of the Republic of Peru, through Banco de la Nacion, with Manufacturers Hanover Trust Bank, Servicing Bank, dated January 3, 1979.

50. Friedman, Op. Cit.

51. Ibid.

52. Robichek, Op. Cit.

53. This view of the balance of payments adjustment process rooted in Hume's analysis of the effects of gold flows on the price level and international competitiveness. For a discussion, see Robert Triffin, The Evolution of the International Monetary System: Historic Re-Appraisal and Future Perspectives (Princeton Essays, International Finance, No.12, 1964; and C. Fred Bergsten, Dilemma of the Dollar (New York: Council on Foreign Relations, 1975).

54. Alejandro Foxley, Stabilization Policies and their Effects on Employment and Income Distribution: A Latin American Perspective, paper presented at the Brookings Institution conference on Stabilization Programs in Less Developed Countries, October 25-26, 1979.

55. I have attempted to develop a critique of the effects of monetarist stabilization policies in Chile. See my "Chicago Economics in Chile" in Challenge: The Magazine of Economic Affairs, September-October 1977; and in Isabel Letelier and Michael Moffitt, Human Rights, Economic Aid and Private Banks: The Case of Chile (Washington, D.C.: Institute for Policy Studies, 1978).

56. Dell, Op. Cit., P. 111-2.

57. Ibid., pp.1-2.

58. See Foxley, Op. Cit.

59. Thomas Reichmann, "The Fund's Conditional Assistance and the Problems of Adjustment, 1973-75", Finance and Development, Vol. XV, No.4, (December, 1978) pp.38-41.

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61. Thomas Reichmann and Richard Stillson, "How Successful are Programs Supported by Stand-by Arrangements", Finance and Development, Vol. XIV, No.1, (March 1977), p.22-

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62. Telephone interview, September 1979.

63. William R. Cline, "Economic Stabilization in Peru, 1975-78", paper presented at the Brookings Institution conference on Stabilization Programs in Less Developed Countries, October 25-26, 1979.

64. Nicholas Ashekov, "Peru Hits the Comeback Trail", Institutional Investor, July 1979.

65. Nicholas Ashekov, "Endgame in Managua", Institutional Investor, September, 1979.

66. For a summary, see National Planning Agency, Economic and Social Survey of Jamaica, 1978.

Chairman NEAL. Thank you, Mr. Moffitt.
Mr. Willamson?

STATEMENT OF JOHN WILLIAMSON, PROFESSOR (VISITING), MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Mr. WILLIAMSON. I understand that the reason I have been invited to testify this morning is that I recently presented a paper to an academic conference endeavouring to identify and appraise the economic theory employed by the IMF in the stabilization programs agreed with member countries desiring to draw from the Fund's conditional facilities. I hope that it will be of help to this subcommittee if I summarize the principle theses of that paper, and then sketch what I conceive to be the implications of my study for the topic before you.

Chairman. NEAL. Do you have the paper for the record?

Mr. WILLIAMSON. I can, indeed, include a copy of the paper for the record.

[The paper submitted by Mr. Williamson entitled "Economic Theory and IMF Policies" may be found on page 214.]

In 1978, IMF lending financed no more than 4 percent of all current account deficits. Furthermore, some 90 percent of outstanding Fund lending was not made under the high-conditionality facilities—the higher credit tranches and the extended facility. However, despite this modest scale of the Fund's conditional lending, it plays a strategically crucial role in the adjustment process. The reason is that it is called on at those times when a country exhausts its creditworthiness with the private capital market, which is nowadays the overwhelming source of finance for current account deficits. A country facing borrowing difficulties may first turn to the IMF's low-conditionality facilities, but if it exhausts the borrowing possibilities there before its balance of payments has recovered, it has little option but to negotiate a standby program with the Fund. That, unlike drawing from the low-conditionality facilities, can reestablish a country's creditworthiness and will therefore typically unlock several times as much credit from the private market as is provided by the Fund itself.

The question addressed in the main part of the paper I am summarizing is: What is the body of economic theory that forms

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the basis for the programs of financial stabilization agreed before stand-bys are granted? In answering that question, I start by recognizing the central role that has been, and continues to be, given to restriction of the monetary aggregates. The Fund is indubitably monetarist insofar as that it is implied by a belief that monetary discipline is the essential central ingredient of any stabilization program. The monetary aggregate on which control is exercised is normally domestic credit expansion, rather than the increase in the money supply. The difference between the two concepts can be shown by the accounting identify: Increase in money supply equals increase in international reserves divided by domestic credit expansion.

Domestic credit expansion—DCE—is therefore what the increase in the money supply would be if there were overall balance in international payments that is, no change in reserves. If DCE is controlled, this implies that any payments deficit—fall of reserves—will be allowed to decrease the money supply. In contrast, if limits were placed on the money supply rather than DCE, this would imply that any decline in the money supply caused by a payments deficit could be made up by additional DCE, which would, of course, tend to maintain demand and thus maintain the payments deficit. With the restriction placed on DCE as in Fund programs, the money supply will fall—at least in relative terms—and thus increase the squeeze on the domestic economy for as long as the deficit persists. It is thus a policy designed to insure that a balance of payments deficit is eliminated, whatever the degree of restriction that may prove necessary to accomplish that objective.

The targets set in consultation with the Fund prior to a standby, and the performance criteria used to monitor access to additional installments, frequently include restrictions on credit to the public sector as well as on the overall level of domestic credit. The main reason for this policy seems to be that in practice it is generally the public sector that is responsible when credit creation gets out of hand, and that in many countries the central bank is too weak to limit on its own authority the credit that it will extend to the government. Credit to the private sector can be an input to the production of tradeable goods, so that it is crucial to insure that the burden of credit restriction does not fall unduly on the private sector.

The Fund also often requires targets—but not necessarily performance criteria—to show how it is intended to secure a programed reduction in credit to the public sector; whether by greater resort to bond finance or by a reduction in the budget deficit; by raising taxes, cutting expenditure, reducing subsidies to state enterprises, or what. At least in principle the Fund takes no attitude as what decisions should be made on these topics, on the grounds that that is an internal matter, but simply requires that some specific decisions be reached and adhered to.

Despite the central role that restriction of DCE plays in Fund-sponsored stabilization programs, it is quite wrong to suppose that the Fund is monetarist in the sense of acting as though monetary policy were the only policy with a role to play in securing stabilization. There are a series of other elements that may frequently be included in stabilization programs: the exchange rate, incomes poli-

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cies—though very rarely—limits on short-term foreign borrowing, and liberalization of trade, payments, and the financial system.

The most important of these additional elements is exchange-rate policy. Devaluation is frequently required by the Fund of countries seeking drawings, in order to secure an adequate level of competitiveness for the export and import-competing industries. The changes demanded can be large, in part because the Fund seems to regard it as desirable to avoid creating an expectation that an initial devaluation will be followed by others. This means that, when—as is normal—it is expected that the devaluation will cause domestic inflation, the initial devaluation has to be large enough to neutralize the effects of this expected induced inflation on international competitiveness.

That completes my sketch of the types of policy measures included in Fund-sponsored stabilization programs. Economists have a reputation for being argumentative, and no doubt one could find some who would be prepared to argue that Fund programs were fundamentally misconceived in one or more of the aspects outlined above. But I believe that they would be in a minority, and that the vast majority of economists—who certainly include me—would accept that, when financial stabilization is necessary to cure a chronic payments deficit, it should follow the general lines that are in fact pursued by the Fund.

Nevertheless, the Fund has the reputation in many of the countries with which it has dealt—particularly in Latin America—of being excessively orthodox, conservative, monetarist. Its programs are widely viewed as being excessively onerous for the countries involved, as often requiring unreasonably heavy deflation or massive devaluation, and as insensitive to the income redistribution that these policies produce. These views were held sufficiently widely among the developing countries to provoke the review of conditionality that the IMF concluded in March 1979.

It is no doubt inevitable that programs aimed at eliminating a deficit will often provoke opposition, since elimination of a deficit virtually always requires some combination of reduced spending, worsened terms of trade, and sacrifice of the position of privileged sectors. Nevertheless, the critics include many serious economists, who point to specific cases where they believe the Fund was unreasonably severe in its demands. Let me mention five instances where, on my knowledge of the evidence, I think the critics have a case.

EXHIBIT I: BRAZIL, 1964

The two most orthodox economics ministers seen in Brazil for many years, Roberto Campos and Octário Bulhões, were installed by the military government that seized power as inflation accelerated past an annual rate of 100 percent. Their stabilization program combined fiscal austerity and a consequent gradual monetary deceleration with a wage squeeze and measures to rationalize resource allocation, including price decontrol and indexation. The Fund objected to the gradualism, the indexation, and, in 1967, to the relaxation of the policy of restraint, despite the large margin of slack that had by then developed.

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EXHIBIT II: COLOMBIA, 1966

In that year Colombia pursued a program of precipitate import liberalization, with the support of the Fund. Reserves were depleted by September, whereupon the Fund demanded an immediate and substantial devaluation and denied further credit until this was conceded. Colombia refused and instead reimposed strict import controls, which were subsequently liberalized gradually *pari passu* with a crawling real devaluation and the induced explosion of nontraditional exports. Greater gradualism in import liberalization and more credit support from the Fund could probably have avoided both the devaluation that the Fund demanded, and the reimposition of controls the authorities chose instead.

EXHIBIT III; UNITED KINGDOM, 1976

The year started with government finances out of control, and accordingly I was a strong supporter of the measures to cut back the projected path of the budget deficit that were taken during the summer. However, the additional cuts demanded by the Fund in the autumn, which largely consisted of pushing back some projected public investment projects from a time when there would clearly be excess capacity in the economy to one which was still beyond the forecasters' time horizon, struck me as clearly harmful on both domestic and international grounds. Remember that this was just when the weakness of recovery from the 1975 recession was becomming apparent.

EXHIBIT IV: PERU, 1977–78

The Peruvian Government and the Fund battled bitterly about the terms of two standby programs. There was no doubt, nor disagreement, that both restrictive fiscal and monetary policies and a depreciation of the exchange rate were needed; the argument was about the necessary degree of severity. The speed and size of the subsequent payments recovery suggests that the Peruvians were basically right. The fact that the bulk of the payments recovery was accounted for by a long-planned and foreseeable expansion of copper and oil production and exports indicates that the Fund should have known better.

EXHIBIT V: PORTUGAL, 1977

It has been argued convincingly that the big step devaluation prescribed by the Fund would have wrecked the deceleration in inflation that was in fact achieved. Portugal decided to crawl down instead of jumping to a new fixed rate as preferred by the Fund.

Of course these five instances cover only a small proportion of the agreements reached between the Fund and its members over the past 15 years, and so they do not prove that the Fund adopts a systematically overrepressive stance. Moreover, if the Fund has to err, there is something to be said for it erring on the conservative side, since this at least preserves its status as an organization whose seal of approval reestablishes a country's creditworthiness with the private market. Nevertheless, my examples do seem to me

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sufficient to suggest that the Fund's reputation for unreasonable severity is not wholly undeserved.

As I have already indicated, I do not believe that the Fund's errors can be attributed to a failure to make use of appropriate economic theory. There is, however, one way in which I have heard it suggested that the Fund sometimes applies theory improperly, and that is in assuming that the burden of monetary restriction will fall on prices rather than output, even in the short run. Unfortunately there is a great deal of evidence that this is not true, and that curbing inflation and payments deficits through monetary restriction must be expected to involve a cost—at least in the short run—in terms of lost output. It will not in general be possible to avoid this cost in designing stabilization programs, but it is a cost that needs to be recognized and estimated if there is to be a reasonable expectation of balancing costs and benefits correctly.

A second criticism that I have of Fund practice concerns the preference for making exchange-rate changes in one large step, even though this may require making a much larger change than is initially necessary in order to allow for the slippage in competitiveness caused by the inflation resulting from the devaluation. An altogether better strategy would, in my view, be to limit the initial devaluation to that needed to achieve a suitable level of competitiveness at the initial price level, and then to undertake such further devaluation as might prove necessary to preserve that level of competitiveness through a series of subsequent small changes—the "crawling peg."

The third criticism that seems to me called for concerns the time horizon adopted by the Fund. A preoccupation with achieving payments adjustment quickly and certainly, even at the cost of sacrificing the principal internal objectives like growth and price stability, can explain the particular sources of complaint noted above; the taste for big and sudden exchange-rate changes, and the instances of support for deflationary overkill. It may be that some bias toward concern with payments balance is useful in order to counteract the tendency for governments to give overriding priority to internal objectives, but the examples cited above suggest that the bias has sometimes been excessive in the past. The Fund might also reply that the need to implement adjustment programs quickly stems from the limited period for which a standby lasts, and the extended facility may have ameliorated this tendency. Nevertheless, I would prefer to see a gradualist philosophy much more firmly established as the basis for Fund policy.

Finally, let me sketch what I conceive to be the implications of what I have said for the topic before this subcommittee. First, I am convinced that the world needs a mechanism whereby it can help a country to reestablish its creditworthiness when, through some mixture of misfortune and bad management, it has forfeited its ability to borrow abroad. I believe that the right type of mechanism to use for this purpose is an international organization such as the Fund, rather than, for example, either an individual government of another country or a consortium of private banks. And I am clear that reestablishing creditworthiness requires that a country make a set of clear commitments, as are provided in Fund

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standby programs. I therefore hope that the subcommittee will strengthen the Fund's ability to fulfill this important role in the world economy, by recommending that the U.S. quota in the Fund be increased. I do not believe that it would be wise for Congress to be deterred from this action by the fact that the Fund has undertaken no net lending over the past 2 years of easy liquidity—a situation that may well change as dramatically following the recent oil price increases as the similar pause in Fund lending in 1971–73 changed following the first oil price increase. And I do not think it is necessarily a criticism of the Fund to say that IMF credit helps insure repayment of credit previously extended by commercial banks, since this surely benefits developing countries through an increase in their access to credit at a reasonable cost through the private market.

Second, while I endorse the principle of conditionality, in the appropriate place, and I see no alternative to policies of the broad character pursued by the Fund, I do believe that there is some scope for improving the structuring of these programs. I have advanced several criticisms: A failure to take adequate account of the cost of lost output in designing programs; an attempt to make devaluations once for all, with the resulting need to make them excessively large; and the desire to achieve external adjustment quickly, irrespective of the cost to internal objectives. The Fund has proved itself responsive to criticisms in the past, and I imagine that efforts by the U.S. Executive Director to use his great influence in the normal workings of the IMF Executive Board would be productive in eliminating the basis for these criticisms—to the extent that they have not already been eliminated by the Fund's acceptance of exchange-rate flexibility, its introduction of the extended facility, and the review of conditionality.

Should one go further than this and seek to build in explicit criteria regarding income distribution and basic needs? On that issue, I would endorse what Dr. Cline has said this morning. In particular, I agree that such criteria should play a major role in shaping long-term development programs. It would also seem to me entirely appropriate to expect the Fund to design short-term stabilization programs to be consistent with, or at least to do the minimal possible damage to, long-term development programs. But I doubt whether it would be prudent to do more than that by introducing what would indeed amount to a new set of conditions on Fund lending. To take the example cited a few minutes ago by Mr. Moffitt, that of Brazil: There might well be a way of designing a stabilization program that would satisfy both the Fund's macroeconomic criteria and the maintenance of real wage growth, by scrapping the nuclear energy program—a program that makes about as much economic sense in the Brazilian context as did, say, the Concorde program in my native country. But I fear that if one starts requiring the Fund to interfere in such preeminently political decisions, one will expose its very existence to grave danger. The question is not just whether we might welcome a curb on national sovereignty in the interest of economic rationality, but also whether such a curb would be consistent with the present realities of international relations.

[The paper referred to by Mr. Williamson at the beginning of his oral presentation "Economic Theory and IMF Policies" follows:]

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Revised Draft, December 1979

Economic Theory and IMF Policies

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A paper presented at the Carnegie-Rochester Conference at Pittsburgh in November 1979.The author is indebted to participants in that conference,as well as to Rudiger Dornbusch, Moshin Khan, and J.J. Polak, for helpful comments on a previous draft, but responsibility remains that of the author alone.

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1. Introduction

The purpose of this paper is that of examining the logic, including its basis in terms of economy theory, of some of the activities of the International Monetary Fund. The paper starts with a sketch of the scope of the Fund's activities, proceeds to a more intensive discussion of the balance-of-payments programs that the Fund agrees with member countries making drawings, and concludes with a discussion of the rationale for the Fund's existence.

The principal source on which I have drawn in preparing this paper is general knowledge acquired over the years, in particular during my period (1972-74) on the staff of the Fund. However, I should emphasize that my responsibilities in the Fund did not impinge directly on the topic central to this paper. This is undoubtedly a disadvantage in that I know less about the subject in hand than presumably I otherwise would have done, but also an advantage in that I do not have to constrain what I say for fear of betraying confidences. This is not a frivolous remark, for the Fund is extremely restrained in the material it publishes bearing on its negotiations on the policies of members, in order to avoid jeopardising its capacity for frank discussion of policy matters. One can respect the reason for this reticence, but it must nevertheless be recognized that it poses something of a problem for academic analysis. At the end of Section 3 I suggest that there is a strong case for seeking to build up, from sources external to the Fund, a systematic body of information and analysis of Fund payments programs to provide a base for informed appraisal; but the present paper has been written without the benefit of such source material.

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2. Scope of the Fund's Activities

The work of the Fund can be classified into that which concerns relations with individual member countries, and that involving general supervision of the international monetary system. Balance of payments programs agreed in support of drawings obviously fall in the first category.

Relations with individual member countries cover a wide range of topics, varying from the routine to matters that can precipitate the overthrow of governments. At the routine end of the spectrum, one has matters like SDR transactions, rapayments of drawings, technical assistance, training programs, and the reporting of exchange controls and statistics. (Even that can, however, be touchy: not only did it provide the immediate issue provoking Czechoslovak expulsion, but major developed countries have been known to refuse seemingly innocuous requests such as for data on the currency composition of their reserves.) Matters which typically have somewhat greater policy content include the regular consulations that the Fund now carries out with all its members, and drawings (i.e., borrowings) from the low-conditionality facilities. In terms of relations with individual members, high policy covers borrowing from the high-conditionality facilities. This provides the topic of the next section, but it is useful first to place it in context by outlining the other non-routine topics listed above.

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Table 1

IMF Lending Outstanding, May 31, 1979 (SDR millions)

Oil Facility	3976
Compensating Financing Facility	2993
First Credit Tranche	794
Buffer-stock Facility	80
Total low-conditionality lending	7843
Higher Credit Tranches	412
Extended Facility	422
Total high-conditionality lending	834
Total lending = "use of Fund credit"	8677
Memorandum item: Trust Fund loans outstanding	970

Source: International Financial Statistics, July 1979, p.16, and International Monetary Fund

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The Fund now carries out regular consultations with all members. They involve a staff mission visiting the country and drawing up a basically factual report about the country's situation, policies, and prospects, which is followed by a staff appraisal. This is discussed in the Executive Board, which thus has the opportunity to keep in touch with developments in member countries and to express views on individual members' policies. The proceedings are concluded by "an informal summation expressing the sense of the meeting", rather than by any formal decision or recommendation.

An idea of the relative importance of the various facilities under which countries draw from the Fund is given by Table 1. The "low-conditionality" facilities are those shown in the top part of the table [1/]. The Compensatory Financing Facility constitutes what may be regarded as the typical case. It provides for primary-producing members that suffer an export shortfall due to circumstances beyond their control to draw a sum equal to the estimated shortfall (defined as the amount by wich the value of exports in a yea: falls short of the Fund's estimate of the average for the five-year period centred on that year), subject to certain limits imposed by the size of the country's quota plus an undertaking that the country will endeavour to find appropriate solutions for any payments difficulties it may have. The Oil Facility was rather similar: countries were able to borrow up to a specified percentage of their estimated "oil deficits", subject to a limit related to quota plus what essentially amounted to a declaration of good intentions, during the two years after the 1973 oil price increase. Drawings in the first credit tranche require only a "program representing reasonable efforts to overcome ... payments difficulties", while the Buffer Stock Facility helps provide finance for members' contributions to approved buffer stocks, subject to an undertaking to seek appropriate solutions for any difficulties. Table 1 reveals that collectively these four facilities, none of which involve negotiation of payments programs with the Fund, have recently accounted for some 90 per cent of Fund lending.

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High-conditionality loans are those made in the higher credit tranches and under the Extended Facility, the sums available under both of wich have recently been augmented by the Supplementary Financing Facility. The higher credit tranches provide the traditional source of finance for a country with a difficult external situation requiring a comprehensive program of financial stabilization. The Extended Facility is a more recent innovation intended to enable the Fund to provide medium-term finance in cases where adjustment requires structural changes and not just financial stabilization. Experience with the Extended Facility is still too limited to permit evaluation (especially by the present author), and so the discussion that follows will concentrate on loans made in the higher credit tranches. Table 2 shows a classification of the "principal purposes" of stand-by programs in the higher credit tranches in the period 1963-72. There were quite a few cases where the balance-of-payments aim was essentially to hold rather than to improve the situation, and the main aim was liberalization or riding out a temporary deficit rather than financial stabilization.

The Fund's activities in regard to supervison of the international monetary system are also diverse. Some involve determination of the general policies governing the Fund's

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Table 2

Classification of Main Purposes of IMF Stand-by Programs in Higher Credit Tranches, 1963-72

Correction of over-expansionary demand policies	26
Modification of exchange system and correction of over-expansionary demand policies	4
Modification of exchange system	20
Anti-recessionary program	5
Cope with temporary shortfall in exports	11
Other (e.g. debt rescheduling)	13
Total	79

Source: Reichmann and Stillson (1978)

discharge of its direct operational responsibilities toward individual members, such as determination of the rules governing access to the facilities listed in Table 1 or discussion of possible new facilities (e.g. the Supplementary Financing Facility, or currently the Substitution Account). The operation of the SDR system also requires considerable work: subjects taken up in recent years have included the rules governing use of the SDR, its valuation and interest rate, and the regular quarterly designation plans that determine which countries may be called on to accept additional SDRs, as well as the issue of new SDR allocations which generated a significant academic literature at the beginning of the decade. More recently, the disposal of part of the Fund's redundant gold stock, both through public auctions and through so-called "restitution" to members, has at times occupied the Executive Board.

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The Fund's new Article IV gives it the responsibility for surveillance of exchange rates, though without endowing it with policy instruments to this end comparable to the need to agree to par value changes provided in the original Articles. To this end the Fund undertakes special consultations with selected countries, in practice principally the major industrial countries with floating currencies It is not clear that this surveillance has as yet had much impact on national exchange-rate policies, and indeed the Fund s influence on the whole area of coordination of macroeconomic policies seems weak. The context for this surveillance and cordination is provided by the Fund's quarterly reviews of the world economic outlook. Unlike the parallel semi-annual OECD exercice, which forms the basis for the OECD Economic Outlook, the results are not published The reviews are discussed by the Executive Board or, when it meets, by the Interim Committee (which consists of Ministers of Finance). I am not aware of whether the multilateral exchange-rate model (MERM) developed by the Fund is used as an input to the reviews of the world economic outlook in order to provide an informed judgment of the appropriateness of the current pattern of exchange rates, but I presume that this would be technically possible and I would regard it as appropriate.

3. Balance-of-Payments Programs

In quantitative terms, IMF lending to countries with agreed payments' adjustment programs is remarkably small. In 1978, Fund lending financed only some 4 per cent of all current account deficits, while Table 1 showed that some 90 per cent of Fund lending is not highly conditional; and, even of the conditional part, some is advanced in support of programs aimed

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at exchange liberalization rather than at payments adjustment. Nevertheless, this quantitatively minor source of finance has a qualitatively strategic role in the adjustment process. Under normal circumstances the private capital markets now finance the vast bulk of all current account deficits (except, perhaps, for the poorer of the developing countries,where reserve movements and official borrowing still retain some of their traditional significance). Sometimes, however a country finds its creditworthiness eroded to the point where private sources of finance evaporate. The country may first turn to the IMF's low-conditionality facilities, but if these are exhausted before the balance of payments has recovered, it has little option but to negotiate a stand-by program with the Fund. That, unlike drawing from the low-conditionality facilities, can re-establish creditworthiness and typically unlocks several times as much credit from the private market as is provided by the Fund itself. The conditions the Fund imposes may have important indirect implications, e.g. in influencing the determination of governments to avoid going to the Fund or in influencing the policies they adopt when they start to fear they may be forced to go to the Fund, which may well outweigh the direct impact of the programs actually agreed.

It is now established Fund policy that drawings in the higher credit tranches be made under stand-by programs. A stand-by is an agreement that a country has the right to draw up to a specified sum during a determined period subject to the observance of certain conditions. It is also now standard policy for the total drawing to be made available in a series of installments rather than all released immediately, and for these installments to be subject to the country satisfying a series of "performance criteria" agreed before the stand-by

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is granted. These performance criteria relate to some of the main macroeconomic policy instruments, targets for all of which are typically specified in the comprehensive program of financial stabilization that is negotiated with the Fund staff before the formal application to draw is submitted.

The question addressed in this section is: what is the body of economic theory that forms the basis for programs directed principally at strenghthening the balance of payments? There are some who might be tempted to answer this question with the single word, "monetarism". It is certainly true that the Fund's programs have given a central role to control of the monetary aggregates right from its earliest dealings in this area, which were principally with Latin American countries, in the 1950s. The Fund indeed published a volume entitled The Monetary Approach to the Balance of Payments in 1977, reprinting a series of papers by staff members written from 1957 on, which staked its claim to have mothered the development of the monetary approach. The introductory essay to that volume suggests that the Fund's 1950s' work in Latin America, which stimulated the theorising that forms the core of the book, was itself inspired by Robert Triffin's distinctions between "money of internal and external origin" during his years in the Fund (1947-51). Harry Johnson (1972, p. 84) once speculated on a somewhat different intellectual lineage, in which J.J. Polak had introduced the Dutch monetary tradition to the Fund (from where it was transmitted by way of Robert Mundell to Chicago). In either event it seems clear that it was in the (extremely open) Benelux countries that the key importance of monetary factors in determining payments'

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outcomes was never lost sight of, even at the zenith of Keynesianism.

Table 3

The Role of Credit Restrictions in IMF Stand-by Programs, 1963-72

Main Purposes of Programs	Credit policy to be implemented	
	Deceleration	No deceleration
Correction of over-expansionary demand policies	26	-
Correction of over-expansionary demand policies and modification of exchange system	4	-
Modification of exchange system	7	13
Anti-recessionary program	-	5
Cope with temporary shortfall in exports	-	11
Other	3	10
Total	40	39

Source: Reichmann and Stillson (1978)

The most eloquent testimony to the central role accorded control of the monetary aggregates in Fund programs directed at payments adjustment is provided by the amplification of Table 2 shown in Table 3. The particular monetary aggregate on which primary emphasis has been placed has varied to some extent, in particular between central bank credit and all bank credit, depending upon the institutional characteristics of the country in question (Horsefield, 1969, vol. II, ch. 21). But in one respect the Fund is fairly consistent: the aggregate on which control is exercised is normally domestic credit

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expansion rather than, in particular, the money supply. The difference between the two concepts consists, as is well known [2/], in money created as a counterpart to reserve acquisition. The significance of this difference stems from what can surely be considered the principal theorem of the monetary approach to the balance of payments: that, with a fixed exchange rate, additional expansion of domestic credit does not increase the money supply even in nominal terms (except in the short run), since all the extra credit leaks out through the balance of payments. It follows immediately that selection of a target for DCE rather than the money supply introduces a stabilizing feedback into the system if the payments balance is deviating from target, since (for example) a continuing deficit will lead to a continual reduction in the money supply under the DCE rule. On the other hand, there is some presumption that a constant money supply is more appropriate if the principal policy objective is that of achieving "internal balance" rather than "external balance". Hence the inference one can draw from the Fund's policies is that the stabilization programs that it sponsors attach higher priority to the achievement of external than of internal objectives. There is in fact evidence that IMF-sponsored programs have enjoyed a measure of success in improving payments positions and liberalizing payments policies, while there is no evidence that they have had any systematic effect in either improving or worsening domestic performance in terms of either inflation or output (Reichmann and Stillson, 1978). One perhaps ought not to be surprised that programs sponsored by an international financial institution charged with supervising countries' external policies should pay most attention to, and achieve most success in, the external sphere.

The targets set during negotiations with the Fund

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prior to a stand-by, and even the performance criteria used to govern access to additional installments, frequently include restrictions on credit extended to the public sector as well as limits on the overall level of domestic credit. The reason given for this policy is the pragmatic one that in practice it is generally the public sector that is responsible when credit expansion gets out of hand, and that the central bank is frequently too weak to limit by its own authority the credit it will extend to the government (Robichek, 1967, p. 14). A similar pragmatic justification, that the country cannot be trusted to deliver on promises of restraint without a blueprint showing how it plans to go about it, presumably underlies the also-frequent demand for targets at disaggregated levels. These showwhether a reduction in credit to the public sector is to be implemented by greater resort to bond finance or by a reduction in the budget deficit, and, in the latter event, whether this is to be done by raising taxes, cutting expenditure, reducing subsides to state enterprises, or what. At least in principle, the Fund takes no attitutde as to <u>what</u> decisions should be made on these topics, on the ground that that is an internal matter, but simply demands that some specific decisions be reached and adhered to.[3/] I am not sure how these practices will be influenced by the new guidelines on conditionality introduced in March 1979, which provide <u>inter alia</u> that "... performance criteria will normally be confined to (i) macroeconomic variables ..." (IMF, 1979, p.83). At least as regards separate credit targets for the public and private sectors, however, a justification might be found in the argument that credit to the private sector can be a crucial input to the production of tradables, while it is rather unlikely that credit to the public sector could have a short-

run payments (or indeed output) pay off (Morley, 1971). An alternative justification is implicit in a recent analysis of the role of government deficits in the inflationary process in developing countries, in which it is shown that negative fiscal drag is normal (Aghevli and Khan, 1978).

Another interesting question about the appropriate form of monetary targets has arisen since the move from a pegged to a floating exchange-rate system in March 1973. If the exchange rate were <u>freely</u> floating there would of course be

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no difference between domestic credit expansion and the change in the money supply, but since exchange rates are not allowed to float freely a difference between the two measures exists, and hence the need to ask on which measure policy should focus. It seems to me that DCE is the more logical candidate in the case where intervention is directed toward an exchange-rate target, while it might be better to concentrate on making the money supply predictable in the case where the authorities are completely indifferent as to the level of the exchange rate and intervention is purely of the "smoothing" or "leaning against the wind" variety.

Despite the central role that restriction of the monetary aggregates, notably domestic credit expansion, play in Fund programs designed to improve the balance of payments it seems to me quite wrong to classify the Fund as "monetarist". There is a fundamental difference between "the monetary approach to the balance of payments" as presented in the Johnson-Frenkel volume of that title and in the Fund collection with an identical title. This difference certainly does not reside in the principal conclusion of the analysis mentioned above, which is in fact one of great generality Neither are differences of model specification of fundamental importance although significant differences of specification certainly exist, these are no greater than the variations that can be found within the respective schools. The basic difference is, rather, reflected in the tone of voice in which the theory was presented. The Fund papers contain none of those scenes from the intellectual Wild West with which one became so familiar a decade later after Chicago had discovered David Hume, with Sheriff Monetarist always locked in a duel to the death with Badman Elasticities or some other Keynesian degenerate, convinced that there was not room for both to live in the world together. On the contrary, the basic Polak paper of

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1957 presents monetary analysis as, among other things, a technique for predicting imports which can provide a substitute for the standard Keynesian method, subject to an additional source of error stemming from variations in velocity, when the income data needed to apply the latter are not available. Many other Fund papers, of which perhaps the most explicit is Blackwell (1977), have treated monetary analysis as one (important) element that has to be integrated, along with such other elements as the elasticities and absorption approaches, into any satisfactory model. In short, intellectually the Fund stands in the eclectic center of the profession and not on its monetarist fringe.

The essence of the eclectic approach is to view questions of macroeconomic policy within the context of a structural general equilibrium model of an open economy. The emphasis in the term "general equilibrium" is on the word "general" rather than "equilibrium"; as a matter of fact, there is now some tendency toward specifying some or all markets as in disequilibrium (e.g., Knight and Wymer, 1978). The elements that have to go into such a model are familiar: in a compex model they would typically consist of a basically Keynesian determination of aggregate demand, modified by the use of permanent income and/or wealth variables; a price/wage determination process, with - unlike a decade ago - a vertical long-run Phillips curve, but with causality still running from unemployment to wage changes; a sub-model in which the current account is determined (with lags) by relative international prices, real demands, productive potentials, and commercial policy, essentially as Meade had sorted things out 30 years ago; a financial sector, at times simplified down to a money-demand equation and a money supply process in which the alternative (internal and external) sources of monetary expansion are recognized; the foreign exchange market (which is where the monetary approach is

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incorporated), consisting of equations explaining the capital account, expectations, and (depending upon the exchange-rate regime) an exchange-market clearing condition; and various identities to reflect the government budget constraint, the evolution of wealth over time, etc. In practice the general equilibrium model actually applied may be extremely simple, consisting of no more than the original Polak model in which nominal income is proportionate to the money supply, imports are proportionate to income, and the change in the money supply is equal to the balance of payments surplus (exports minus imports) plus domestic credit expansion. But even that model, if applied with any degree of sensitivity (notably regarding the price-output break-down of nominal income), can accommodate an eclectic view of the world.

Acceptance of on eclectic framework has two important implications. The first is to suggest that Keynesian policies "work", in the sense of increasing output, though at the cost of accelerating inflation; conversely, stabilization policies "work", in the sense of restraining inflation and improving the current account, though perhaps at the cost of lost output [4]. There are none of those paradoxical results about the inability of anticipated monetary expansion to increase output that come from marrying rational expectations to Lucas-type supply functions, nor of those optimistic beliefs that it is possible to expand out of inflation. The second consequence is that there are a series of policy variables whose setting is conceived as being important to satisfactory operation of the economy: Fund programs typically do not limit themselves to monetary restriction [5]. It is to a consideration of Fund policy toward these other variables that we now turn.

With the exception of the fiscal adjustments

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necessary to give effect to monetary restriction, which have already been mentioned, the most important additional policy instrument is the exchange rate. The Fund has frequently recommended devaluation as a part of a program to improve the balance of payments. Exchange-rate changes are regarded as an instrument to correct relative international prices when domestic costs and prices are out of line with those of competitors, in accord with the elasticities analysis, rather than as an alternative to monetary restriction in deflating real cash balances (for which purpose monetary policy provides a superior alternative). The determination of a desirable devaluation requires three steps.

The first step involves the selection of an appropriate medium term current account target. Most of us would presumably argue that this should be equal to (the negative of) the "sustainable" or "underlying" capital flow, which we would expect to reflect both movement toward and changes in international portfolio equilibrium (presumably characterized by the marginal productivity of domestic investment being equal to the marginal cost of foreign borrowing). Just what these familiar concepts imply in concrete instances is, however, far from self-evident, and in my view the academic community has been lax in ignoring the problem of deducing their implications for payments aims. Interpretation is, therefore, extremely ad hoc in practice.

The second step involves calculation of the desirable real exchange rate. In addition to a target current balance, one needs estimates of the impact of cyclical factors, of transitory events, of lagged effects in the pipeline, and of trends, in order to be able to calculate the desirable medium-term change in the current balance. Given all that, one can use the best available (generally conventional) estimates of

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the foreign trade elasticities in order to calculate the desirable change in the real exchange rate.

The third stage of the analysis is subject to a greater margin of uncertainty. This is to find the nominal exchange-rate change needed to produce the desired change in the real exchange rate. At one time, when the Keynesian assumption of rigid wages was not obviously inappropriate, it was possible to make a conventional assumption on this issue as well. That is no longer sensible. The Fund customarily makes some allowance for probable "slippage" in the domestic price level in calculating the necessary change in the nominal rate. My impression is that this is done on a pretty ad hoc basis, and I can see no way of improving on that, given the Fund's general policy of seeking to go immediately to the new equilibrium nominal rate.[6/] It is true that many modellers have sought to answer the question as to the proportion of any nominal depreciation that will be offset by inflation, which is exactly what one needs to know. However, I can see no reason for believing that this is a question with a meaningful answer, i.e. I believe the answer is: it all depends. If one starts off from a situation of general equilibrium, one surely expects a coefficient of unity. However, governments do not generally devalue with the object of perturbing a situation of general equilibrium. The extent to which they can use a policy of devaluation to gain general acceptance of a reduction in real wages that is necessary to restore general equilibrium depends on the degree of social consensus they succeed in fostering, which is not easily predictable, and can certainly not be deduced from a set of equations estimated on the basis of data covering the previous 15 years. Ergo, one should not expect to be able to identify a stable coefficient linking depreciation and the induced offsetting rise in the price level.

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The conclusion I draw from this is that the Fund is misguided in seeking to identify ex ante the equilibrium nominal exchange rate. The alternative is to restrict the initial devaluation to that necessary to secure the target real exchange rate with zero "slippage", and to follow up with such crawling further depreciation as may be necessary to defend that real rate against whatever domestic offset happens to occur. This has two potential additional advantages. One arises if, as I am prepared to conjecture, attempts to produce precipitate changes in real fixprices are particularly prone to generate defensive reactions: in this event the avoidance of initial over-devaluation would be less inflationary than present Fund policy. The second advantage stems from a reduction in the danger that the stabilization program will be undermined through a loss of monetary control caused by a massive influx of capital, since the expected downward crawl would dampen the foreign-currency return corresponding to the high domestic interest rates during the stabilization period.

It may be noted that the Fund has in effect mechanised the second and third stages of the analysis so far as the industrial countries are concerned, since each of them appears individually in the MERM (multilateral exchange-rate model) which is described in Artus and Rhomberg (1973). The MERM treats similar goods produced by different countries as differentated products with determinate substitution elasticities between them, and also contains expenditure elasticities for each of the five classes of goods distinguished (food, materials, fuel, manufactures, and non-traded goods) in order to determine the distribution of demand corresponding to any given pattern of prices and nominal expenditures. The supply side allows for the transfer of resources between sectors in response to price changes and for the adjustment of wages to the cost of

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living; since this is assumed to be governed by a fixed coefficient, the model is vulnerable to the criticism that I expressed above. Given the requirement that demand be equal to supply for each class of goods produced in each country the model can be employed in order, for example to predict the change in the trade balance(s) that would occur in response to a given change in one or more exchange rates, holding output constant in each country. This is a pure application of the "elasticities approach"; naturally the model also tells one the change in expenditure in each country that would be necessary to legitimate the constant-output assumption. Alternatively, the model may be used to predict the change in the trade balance(s) that would occur in response to given changes in one or more exchange rates, when output is adjusted to "full employment" in each area. The model will again give as an output the change in expenditure necessary to support the simultaneous changes in trade balances and cyclical adjustments.

The choice as to whether to employ the MERM in preference to manual methods is not of great importance so far as the smaller industrial countries are concerned, since the rest of the world can in their case reasonably be taken as exogenous to their own actions. In the case of the large countries, however - i.e. the United States, Japan, and Germany, and possibly the other countries represented at summit meetings - it is clear that such an assumption of exogeneity would be misplaced. It is here that use of the MERM becomes crucial. My own judgment is that the MERM is well specified for the purposes for which it is used, with the exception of that fixed link between price and wage changes.

One method of seeking to reduce the degree to which nominal depreciations are neutralized through inflation is by

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the implantation of an incomes policy. These have on occasion been included in Fund programs, but they are not a regular feature. Since the Fund has never exhibited doctrinal antipathy to incomes policy, it is interesting to ask why their inclusion has been so rare. I would speculate that the answer is essentially that the Fund regards its first duty as being to ensure that the adjustment process works, and this can be adequately fulfilled by ensuring control of nominal demand. An incomes policy is intended to affect the price/output composition of nominal spending rather than its level, and therefore tends to impinge on the pain of adjustment rather than its effectiveness. Presumably a country in which markets are not sufficiently competitive to make incomes policies redundant, and in which there is sufficient social consensus to make them practicable, can be relied on to implement such a policy without being prodded by the Fund. On the other hand, numerous ineffective attempts to institute incomes policies attest all too clearly that nothing is gained by having a government legislate an incomes policy that does not reflect a genuine social consensus. Since the Fund can hope to influence only what governments legislate and not the degree of social consensus they command, one may conclude that it is well advised to keep out of the incomes policy field.

A more common feature of Fund programs is the inclusion of limits on the short-term and medium-term debt that a country may contract. This may at first sight seem paradoxical, inasmuch as it limits the extent to which a country may improve its balance of payments through capital inflows despite the fact that the object of the exercise is precisely that of improving its balance of payments. In fact, however, it is perfectly reasonable given that any sustained payments improvement requires current account adjustment, which can

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easily be undermined by monetary expansion even if this is caused by a capital inflow prompted by a restoration of confidence.

The remaining measures that feature in Fund programs are concerned with price decontrol, liberalization of restrictions on trade and payments and of the financial system, and abolition of multiple currency practices. As already noted, such liberalization constitutes the basic objective of quite a number of stand-by programs; it may also be an element in programs directed principally at improving the balance of payments. The theory implicit here is the standard neoclassical presumption that the price mechanism provides an efficient instrument for determining resource allocation, while widespread administrative intervention is apt to lead to distortions and economic waste.

The breadth of the topics that have on occasion figured in Fund programs supports my claim that the Fund is intellectually eclectic. Nevertheless, it has the reputation in many of the member countries with which it has dealt, particularly in Latin America, of being orthodox, conservative, and monetarist. Its programs are widely viewed as being excessively onerous for the countries involved, as often requiring unreasonably heavy deflation or massive devaluation, and as insensitive to the income redistribution that these policies produce. These views were sufficiently widely held among the developing countries to provoke the review of conditionality that was concluded in March 1979 (see IMF, 1979). It is surely necessary to make some attempt to assess the validity of these criticisms.

It is of course true that adjusting away a deficit is virtually always unpleasant, since it normally requires some

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combination of reduced absorption, worsened terms of trade, and sacrifice of the position of privileged sectors. Given the reluctance observable in certain quarters to attribute anything unpleasant to causes other than imperialist/capitalist conspiracies, one could take it for granted that the Fund was not fulfilling its duty to the international community if protests against Fund policies were never heard. Evaluation of the Fund's record therefore requires detailed consideration of whether the means utilized were really necessary to the ends desired in a series of individual cases, rather than simply noting that protests are rather frequent. Unfortunately there does not as yet exist any systematic, critical appraisal of Fund programs written from a middle-of-the-profession position[7] that could provide a basis for evaluating the degree of truth in the critics' position. In the absence of such background material, I shall have to content myself with recording a number of cases where there seems to me a strong case for believing that the Fund was unreasonably severe in its demands.

Exhibit I : Brazil, 1964. The two most orthodox economics ministers seen in Brazil for many years, Roberto Campos and Octávio Bulhões, were installed by the military government that seized power as inflation accelerated past an annual rate of 100%. Their stabilization program combined fiscal austerity and a consequent gradual monetary deceleration with a wage squeeze and measures to rationalize resource allocation, including price decontrol and indexation. The Fund

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Exhibit II: Colombia, 1966. In that year Colombia pursued a program of precipitate import liberalization, with the support of the Fund. Reserves were depleted by September, whereupon the Fund demanded an immediate and substantial devaluation and refused further credit until this was conceded. Colombia refused and instead reimposed strict import controls, which were subsequently liberalized gradually pari passu with a crawling real devaluation and the induced explosion of non-traditional exports. Díaz-Alejandro (1976 ch.7) has argued that greater gradualism in import liberalization and more credit support from the Fund could have avoided both the devaluation that the Fund demanded and the reimposition of controls the authorities chose instead.

Exhibit III: UK, 1976. The year started with government finances out of control, and accordingly I was a strong supporter of the measures to cut back the projected path of the budget deficit that were taken during the summer. However, the additional cuts demanded by the Fund in the autumn, which largely consisted of pushing back some projected public investment projects from a time when there would clearly be excess capacity in the economy to one which was still beyond the forecasters' time horizon, struck me as clearly harmful on both domestic and international grounds. (Remember that this was just when the weakness of recovery from the 1975 recession was becoming apparent.) See Fay and Young (1979).

Exhibit IV: Peru, 1977-8. The Peruvian Government and the Fund battled bitterly about the terms of two stand-by programs. There was no doubt, nor disagreement, that both restrictive fiscal and monetary policies and a depreciation of the exchange rate were needed: the argument was about the necessary degree of severity. The speed and size of the subsequent payments recovery suggests that the Peruvians were basically right. The fact that the bulk of the payments recovery was accounted for by a long-planned and foreseeable expansion of copper and oil production and exports indicates that the Fund should have known better. See Williamson (1979).

Exhibit V: Portugal, 1977. Dornbusch (1979) has argued that the big step devaluation prescribed by the Fund

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would have wrecked the deceleration in inflation that was in fact achieved. (Portugal decided to crawl down instead of jumping to a new "fixed" rate as preferred by the Fund).

Obviously the scattered exhibits cited above do not amount to a proof that the Fund adopts a systematically over-repressive stance. Moreover, if the Fund has to err, there is something to be said for it erring on the conservative side, since this at least preserves its status as an organization whose seal of approval re-establishes a country's creditworthiness with the private market. Nevertheless, they are surely sufficient to at least suggest that the Fund's duty as guardian of the adjustment process might be adequately fulfilled with a rather less restrictive policy stance. What seems to me to need questioning is not, however, the eclectic theoretical framework employed by the Fund, but rather its policy priorities and time horizon. A preoccupation with achieving payments adjustment quickly and certainly, even at the cost of sacrificing the principal internal objectives like price stability and growth, can explain all the particular sources of complaint noted above: the taste for big and sudden exchange-rate changes, the support for deflationary overkill, and the cavalier attitude toward income redistribution. No doubt such a bias is natural, given the Fund's role as guardian of the adjustment process on behalf of the international community. And perhaps some bias in that direction is desirable, given the well-established fact that governments are overwhelmingly motivated by internal objectives. The fact remains that the examples cited above suggest that, at least in the past, the bias has been excessive. Whether such moves as the greater acceptance of exchange-rate flexibility, the establishment of the Extended Facility, and the review of conditionality have now reduced the bias to an appropriate level is not someting on which I am prepared to venture a

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In answering these questions it is useful to distinguish between the low-conditionality and the high-conditionality facilities of the IMF. Taking the Compensatory Financing Facility as the prototypical case of a low-conditionaly facility, the logic is that a country is entitled to automatic access to credit in order to finance a temporary deficit due to certain circumstances beyond its own control. In essence, this provides insurance against a class of risks which would not seem well-suited to a private market (and which have certainly not in the past been insurable in any existing market). No doubt this insurance scheme receives a certain subsidy from the international community at large, but since that represents a net transfer to primary-product exporting countries, most of which are relatively low income countries, I do not regard that as ground for criticism. The important point is that moral hazard is minimized by the fact that the finance is available only to meet deficits due to circumstances outside of the country's own control Admittedly this safeguard is not present in drawings from the first credit tranche, which in fact leads me to prefer any extension of the Fund's low-conditionality lending to be done through a broadening of the principles involved in the Compensatory Financing Facility [8/] rather than through an extension of first-tranche conditionality into the higher credit tranches. I doubt, however, whether the fairly marginal interest subsidies on first credit tranche drawings provoke sufficiently strong perverse incentive effects to merit great concern.

The logic of the high-conditionality facilities is surely quite different: they are intended to aid the recovery of countries that forfeit their creditworthiness often as a result of misgovernment. In general a set of policy reforms adequate to restore a country's situation in the medium term should not be expected to eliminate its current account deficit immediately, since the cost of an abrupt adjustment is typically very high. (One of the best-documented facts about the balance of payments is that long-run elasticities are much higher than short-run elasticities.) The question is whether bankers could be expected to lend (on other than penal terms) in order to tide countries over that difficult gap before visible evidence of recovery became available. Presumably even if they were so willing they would require assurance that

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judgment, but it is certainly something that should be monitored by the profession in the light of future events.

4. Does the World Need an IMF?

A question that prompted considerable discussion at the Carnegie-Rochester conference where this paper was presented is whether the IMF has any business existing. The basic argument against can be found in the accompanying paper of Vaubel: that provision of balance-of-payments finance on concessional terms gives an incentive to countries to qualify for this assistance, which they can do by adopting policies more inflationary than those of their partners.

It should first be remarked that this critique is directed exclusively at one part of the Fund's activities,namely that part dealing with the provision of loans to countries confronting balance of payments difficulties. The Fund also has played, plays, and/or could play a role in at least two other areas: that of coordinating macroeconomic policies, and that of restraining individual member countries from depredatory monetary actions. (Competitive devaluation was the classic example;exchange controls might be another). One may be critical of the Fund for not having done more in these areas in recent years, or one may believe that if only all governments would accept one's preferred set of automatic policy rules these roles would become redundant. But it requires some pretty extreme views along one or other of these lines to write off these other roles of the Fund. Furthermore, the Fund also operates the SDR system, and while this may be a dispensable frill at the moment, it does provide a nucleus which greatly extends the range of possible future developments of the international monetary system.

What logic is there, however, in having an international institution that provides finance to countries in balance of payments difficulties? Why not leave this task to the market? Can credit-worthy countries not rely on getting loans from the private market, and should non-creditworthy countries be able to get loans at all?

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However, commercial banks are not well suited to fulfill the role of negotiating necessary policy changes with sovereign governments - partly because they are at an informational disadvantage as compared to the Fund, partly because optimal competitive strategies for individual banks may not add up to coherent pressure for rational policies, and partly because neither commercial banks nor the governments of their home countries seem likely to be able to play the role of the foreign bogeyman who can be blamed for unpopular policy changes, at lea t not without a dangerous fanning of nationalistic flames. An international cooperative of which one's own country is a member may well be the ideal candidate for this role.

Whether the IMF need itself provide credit, and whether in that case the credit should not carry a commercial interest rate, is more debatable. There do, however, seem to be some advantages in the institution that negotiates the necessary policy changes being in a position to put up a fair bit of money directly, rather than simply giving a seal of approval that with luck will induce the private market to resume lending. And perhaps there is something to be said for a small act of solidarity by the international community to a country that has set about reform after a period of populist misgovernment, instead of magnifying the problems faced by the reforming rulers as occurs when loans are available only at interest rates that reflect the problems inherited from the past. The Fund's conditions no doubt should be, and are, tough enough to avoid the problem of moral hazard.

In summary, I think there is a perfectly respectable case for having a Fund constructed roughly in accord with its present form. Note, however, that the logic of the high-conditionality facilities demands that the Fund adopt a medium-run time perspective for adjustment, whereas it was suggested in the previous section that the Fund has (at least up to now) been over-disposed toward shock treatment.

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conditionality, but [illegible]
of Fund gold rather than through the Fund's regular resources. They are highly concessional loans restricted to the poorer member countries.

1. Nowadays. As late as 1968 the Fund took some of its leading staff members to London to educate the UK authorities on the point.

3. Those of us who come from countries with oversized bureaucracies and wildly-irrational subsidy programs, and who have repeatedly seen our governments placate the Fund by the politically-easy route of further squeezing modest public investment programs, have been known to wish that it were a little less punctilious in its respect of national sovereignty.

4. It is reputed that this cost is sometimes downplayed or even ignored in some of the Fund's operational work. To the extent that this is true, my evaluation of the Fund is distinctly over generous.

5. Any more than eclectics typically recommend confining anti-inflationary policy to monetary restriction, even though they may regard the latter as a necessary and sufficient condition for reducing inflation.

6. It is certainly not true that the Fund always insists on a country going straight to a new rate which it is expected to try and make stick, but there seems to be an institutional bias in that direction. I also have an impression, but no evidence, that the strength of that bias varies among the area departments.

7. Cheryl Payer (1974) provided a fairly systematic and certainly critical survey, but she would undoubtedly be insulted by a suggestion that her position was anywhere near the center of the profession.

8. A broadening of this type has recently been suggested in a UNDP/UNCTAD Report (1979), which urged the provision of low-conditionality finance for all deficits due to factors outside a country's own control.

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Chairman NEAL. Thank you, Professor Williamson. We attempted to attract to the panel a wide variety of opinion, and I think we have succeeded in that.

I would just like to thank the panel for their very significant contribution to our consideration of this bill. I would like to just for a moment or two zero in on Peru. It has been referred to by all of the panelists.

As I remember the situation—and please correct me if I am wrong—a military government—a strong, authoritarian, military government came into power in the late 1960's—1968 or something like that—and was replaced by another government a couple of years later—some time later—and replaced by a government, a military government with great social consciousness. In fact, that military government attempted to bring about many reforms in the economy. And it would probably be accurate to say that it laid the groundwork for the problems that Peru later experienced.

Then, as someone else referred to them, a series of very unlucky circumstances—the anchovies not running, the oil field discovery and the building of the pipeline not working out as anticipated, world copper prices falling dramatically, and then Peru's involvement with the IMF—my basic question is—even though I would agree with what Professor Williamson says about the desirability of the Fund—maybe being less severe in its requests for specific conditions by spreading out the terms and so on.

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My conclusion would be that it is totally unfair to blame Peru's present problems on the IMF, that the problems had their genesis in these other areas that I mentioned, and that Peru would be infinitely worse off if it were not for the IMF.

I would welcome any comments you might have on my rather sketchy analysis of Peru's history and also this question, the very basis question of whether a country is better off with or without IMF.

Father BURNS. First of all, in terms of historical observation, I guess by their nature, most military governments are authoritarian or totalitarian, but there are degrees of variance. The first military government which came into Peru was a progressive—if you want to call it that, progressive in relative terms—government which tried to initiate social reforms.

The second military government which came was less than progressive, and this turned out to be a very repressive government. Historically, it developed that way.

Second—and among the elements you mentioned, Mr. Chairman, you forgot to mention the banks as an element in this particular issue. I think this is very important because the IMF shows a great sensitivity to the banks and a lack of sensitivity to the people—a great sensitivity to balancing the budget but a lack of sensitivity to bread on the table. And I think that is the gut issue.

I think the question to me is whether we are humanly capable, as a race, of trying to do something for other people. If we are humanly capable to taking into account the implications of coming up with a new type of structuring which will take into account people rather than just books with regard to the problems you address, there is no doubt that the military government in Peru is in large degree responsible for the debt situation.

I think I tried to clarify that in my testimony—nobody here is debating that, I don't think. The problem is the solution. My criticism is of the IMF-Peruvian Government-approved solution to the problem which existed. My problem is also with the banks who went in—in my testimony, the quote is there—they went in to sell loans, and seeing the situation was getting bad, to preserve the new President in power—because of a political situation, went into a stabilization program and therefore exacerbated the problem.

My problem also is the much debated question of the conditionality of the International Monetary Fund when it was imposed—I shouldn't say imposed; I don't want to use that word because I think it is a question of an agreement—there is a dialog or a battle, for the most part—the problem is with that solution. The conditions that were put on were unreasonable and impossible and, according to a Peruvian economist who just finished publishing a work, they were impossible to meet and caused an inflationary spiral as a result.

With that, I think—I had something else to say.

Chairman NEAL. Let me just make a couple of comments, if I can.

In the first place, the Fund doesn't bail out banks. That is, if the Government of Peru wants to default on its loans to banks, it can certainly do that. The reason most governments don't do it is because it cuts them off from the future—from future opportunities

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to borrow money. And that is the reason that they do it—not that somehow the Fund is going to bail out the bank. And I am glad you said that you did not want to use the word "impose these conditions", because I think that is correct. The Fund does not impose conditions on countries.

The country doesn't have to borrow. No country is forced to borrow from the Fund, and I guess the bottom line question to me is whether it makes sense or not to, say, protect this generation of babies in preference to the next generation of babies.

I have seen the conditions you are talking about. They are absolutely horrible. The question is, as you suggest, how do we get out of this situation, and I just don't know. But it does not appear to me that the solution is to—in trying to do as much as possible, for members of this generation to not provide the kind of stability that will allow a viable economy to produce and provide for the next generation.

It seems to me that that is the basic question.

Father BURNS. I would like to make two comments, if I may.

First of all, the question of imposition. To say that it isn't imposing, it is because I can't prove it. There is an aura of mystery about the International Monetary Fund, and so I don't want to be caught in that question. But when you have all of the cards in your hand—and there was a tremendous debate in Peru—four Finance Ministers in a period of, say, a little over a year. You know, it is like—I will use something ridiculous to sum it up. Maybe it is like going to the godfather and the godfather saying, "Make me an offer I can't refuse." I mean, your back is up against the wall. That is the reality of the situation.

You know, by saying they didn't impose, that also implies that the IMF bears no responsibility for the results, and I really want to debunk the idea that when you make a decision—a mutual decision in a particular situation—that you are not responsible for the results. That is like saying to somebody, "I want you to hit this target," and he has a gun—an empty gun—so you give him a few bullets, and you say, "Shoot" and he shoots, and there are cries out there—people screaming—and he says, "Well, I am out of bullets, but I still can't hit the target."

Well, you give him more bullets. The IMF goes in every 3 months to see this, and people are screaming.

Chairman NEAL. Would Peru be better off without the IMF?

Father BURNS. I am not saying that. I am talking about the conditionality which the IMF agrees to with the Peruvian Government.

Chairman NEAL. Peru would be much better off if it could attract a massive aid program. What you are suggesting, what you are arguing for is aid for Peru, and I agree with you that it needs the aid.

Father BURNS. That is a very good question. I don't agree with that. If the IMF conditions were not so terrible in this particular situation, it seems to me aid would not be necessary, No. 1, if it were a longer range program and spaced over a longer period of time, if it took into account as the IMF Charter puts as one of its priorities—article I—increasing employment—rather than decreasing employment 12 percent in a period of 2 years.

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If it took into account the people and the results, the obvious results—I mean, I belong to Maryknoll. We are in Sudan—riots in the streets. Tanzania just finished refusing to negotiate with the Fund because of the implications with regard to the Fund. Maryknoll is in Nicaragua. Maryknoll is in Brazil. This situation is coming to head there, and the recent practicial destabilization and riots in the streets in Bolivia are a function of the IMF—I could talk about Korea. I could talk about the Philippines which imposed martial law 1 year after, the IMF came in or India—in the Philippines it was imposed at the same time. In India, martial law was imposed 1 year afterward. It eventually brought the downfall of Indira Ghandi.

These are a series of histories which say that bullets are being shot, riots are caused, and people are screaming; and they come back and say that we were not responsible, we did not have anything to do with that, that we shouldn't reassess what is happening, that we should not question what is going on, that we should not see what the monetary effects and political effects of our policies and say its not political or immoral—to me is pie in the sky.

Chairman NEAL. The IMF is often blamed by governments for conditions because it is much easier for the government to blame it on someone else than on themselves.

Father BURNS. I agree with that. The IMF is used as a lightning rod. The banks use the IMF as a lightning rod to take the flak, too. In the case in Peru, it is very clear. There was conditionality, and I spell it out here what the conditionality was.

The people are not fooled. The people are not happy with the government in Peru. The political implications of this are very serious. I cannot overstress that. The government tries to use the IMF as a kind of lightning rod and an escape valve, it is true. There is no doubt about that.

The banks do it—I think that is also true. But there is a big cloud here. I think it is very important. People don't question the banks. They don't want to say, "What is going on with you guys? What are you doing?"

The whole Western World's economy is in an uproar. You talk with economists around here—I came here thinking I don't know anything about economics, and I found economists in great doubt. Everybody is running around worried about what is going on, but nobody questions the banks.

And there is a great sensitivity to that. Don't go near them. But when the people go out and rise up and say, "What's going on here?" . . . well, ignore them. Keep the program going.

It shows where the options are in life. The fundamental question in this situation is can we face the reality of life from the point of view of people, or do we face the reality of life from the point of view of the institutions which are doing these things to people—preserve those institutions? What is our decision?

Do we move from—you know, this word "reality"—you have to have the belt tightening. You have to have this austerity program, even though austerity really means starvation, you have to have that because we have to go through the crunch and face "reality".

The reality is—other people will say, "the banks are doing something to the people." The fundamental question here is from where

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do you start facing reality? Do you start facing reality with the program of those who don't need personally? If you start facing it from there, that is a very important moral and ethical question.

And that is why I am here. We come from a Judaeo-Christian tradition. The Judaeo-Christian tradition says the option—the fundamental option in life is for those most in need. If we keep answering to the banks and ignoring those in need, we show where our cards lie.

And I think it is very important that we take these ethical questions into consideration. We all have to face the reality of life, and reality is tough. Reality really at times is hell, but we have to face it. And the question is, where do we start facing it from?

Chairman NEAL. Mr. Reuss?

Mr. REUSS. Thank you, Mr. Chairman.

Again, I want to congratulate you for convening this very well balanced panel of witnesses.

Mr. Moffitt, you had an interesting case study of Peru, and I think we have to proceed by case studies, rather than abstract across-the-board considerations, in which you pointed out that the large American banks 10 years ago, dazzled by the prospect of canyons of copper and oceans of oil, made huge loans—and it is certainly true, I believe, that as a result of the IMF's activity, default in those loans was prevented.

You make the point that—and I am quoting from you—this is using taxpayers' money to compensate Citibank and Chase Manhattan for imprudent loans they have made.

Putting that question to one side, isn't there in terms of the average householder in Jamestown, N.Y., or the small businessman in Omaha or the North Carolina independent borrower—isn't there a problem here if the U.S. banking system is encouraged by the prospects of an IMF bail out to make imprudent loans to LDC's at high interest rates? Doesn't that simply subtract from the pool of capital available to people in the United States and also greatly increase the interest rate because the domestic industry tends to reflect what the banks can get for it the wide world over? Would you think there is a domestic point there to be considered as well?

Mr. MOFFITT. Yes, Mr. Chairman, I would. I think that there is no question that the incentives are in the order of expanding the Euromarket, which I would maintain complicates our stablization policy.

The situation which you raise about the person in Jamestown or Omaha who wants to borrow money is one instance. Another instance is the inflationary effect on our own domestic economy of the inflow of funds from the Euromarket.

Mr. REUSS. But that is a different point.

Mr. MOFFITT. Yes. I would certainly support the discussions that have been going on at the BIS to begin to see what we could do about putting reserve requirements or some other form of regulation on the Euromarket.

Mr. REUSS. Thank you. I did not want to get into the whole question, but, Dr. Cline, the IMF decision of March 2, 1979, on access to resources from the Fund and use of standby arrangements provides in section 2 that no matter how desirable it might

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be for a standby arrangement to extend for a period beyond 3 years, it may not be done.

Isn't that a little doctrinaire? In an extraordinary situation where it can be demonstrated that the standby arrangement for 4 years, for example, would be consistent with the most prudent Friedmanesque use of the IMF treasury, should the IMF by its own self-denying ordinance prevent itself from doing the right thing?

Dr. CLINE. Well, I think the issue involves here the availability of funds through different channels. We have the supplementary fund facility, the extended fund facility, and we have seen a growth of things like compensatory finance and other Fund channels that do have longer terms. And I think your question goes to the question of, do we have enough resources in channels with longer term lending, and I think I would agree with Professor Williamson that we do need to continue looking for longer term funds.

I do think, however, that one has to look at the total availability of resources. And it seems to me that one of the principles that is behind the idea of limiting the normal quota process to 3 years, which is already considerably longer than the traditional 1-year period, is that we consider these funds to be revolving funds with a limited supply, and then if we can generate more international resources of longer term funds, that would be all to the good.

I think especially building on the pattern of the Witteveen facility where we bring in the OPEC surplus and put it through a channel that has longer terms would be all to the good. But I think the way you phrased the question, in some sense, it is difficult to disagree with you.

Mr. REUSS. Good. Then you agree that the March 2, 1979, decision could stand a little revisiting?

Dr. CLINE. In the context of the total availability of funds with longer term horizons, yes.

Mr. REUSS. You point out, Dr. Cline, in your statement—and I will quote from page 11—you refer to the March 2, 1979, guidelines of the IMF, and then you say:

> It would be ironical to impose new conditions in this area just when the developing countries thought they had won new autonomy in the application of IMF conditions.

Do you regard the March 2, 1979, decision as a charter of achievement for LDC's and a loosening up of the IMF?

Dr. CLINE. I think the developing countries considered it to be a step forward. I don't think that the Group of 77 would say that it satisfied all of their objectives on Fund conditionality. But I think they would agree that it was an improvement over what they had before. I think what we are proposing here or what some people seem to be proposing would be considered by the Group of 77 to be a step backward.

If the Group of 77 were presented with an amendment that said that they had to pass a new condition, which was income distribution, I think they would say, wait a minute, that is pushing the whole momentum of the autonomy issue in exactly the opposite direction.

Mr. REUSS. Well, I haven't discussed it with all of the Group of 77, but in my office as recently as yesterday was the finance minister with his entourage of one of the countries which has been

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very much in our discussion this morning, who agreed with me completely that the March 2, 1979, guidelines needed to be broadened so that consistently with the application of sensible fiscal and monetary macroeconomic considerations on the LDC borrower, the mind of IMF lenders be focused on the end result of the whole exercise, which I take it is less infant mortality, better health, education, housing, jobs, reasonable prices, and all the other good things.

So I shall continue my vote count among the Group of 77. But I can assure you that nonenthusiasm was expressed by at least one very distinguished finance minister.

Dr. CLINE. Mr. Chairman, may I just——

Mr. REUSS. Yes.

Dr. CLINE. I think they would be very happy if the language on the guidelines made some general reference to "shall also take account of the income distributional implications, the situation of the poor." I think they would be very unhappy if there were a new legislative mandate to the U.S. Executive Director that he must vote against an agreement that the IMF had worked out with a developing country because the agreement did not meet a predetermined condition on income distribution. Because I think that is the kind of thing that would sound very much to them like the kind of basic human needs controversy that we have seen in the context of the United Nations, the whole North-South dialog. I think it is a question of defining what you are really proposing. If you are proposing no more than taking account of poverty, then I think you are completely right that there would be a great deal of responsiveness to that.

Mr. REUSS. I am glad to hear you say that, because the main thrust of the amendment which I have prepared and submitted to Chairman Neal's subcommittee would be to require that IMF personnel have a little matrix before them which requires that they consider questions like jobs, prices, education, health, housing, income distribution, and so on. And I am glad to hear you say that that intellectual exercise wouldn't disturb you.

The question becomes quite important this year. Like yourself, I feel that more resources have to be put into the international monetary agency, whatever it be. Those who felt that view and every other year or two battle with our U.S. Treasury about this have always been at a disadvantage because the IMF was the only game in town.

Now, of course, you have got the Brandt Commission going to suggest in a couple of days that a new world development fund would be set up. So we in Congress are at last in a position to say to the IMF: Climb down from your highly paid in-house country club, macroeconomic high horse, and start looking at the ends of the International Monetary Fund, which, reading from the 1945 Bretton Woods articles of agreement are—I quote—"the promotion and maintenance of high levels of employment and real income, the development of the productive resources of all members."

And it goes on to say that when you, "correct maladjustments in their balance of payments," do it, "without resorting to measures destructive of national prosperity." Many of us think that the wisdom of the Founding Fathers has been subjected to so many

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years of bureaucratic overlay that you can't read the tombstone for the moss.

And let's see. The Treasury is represented here. I want to signal the Treasury that it might be well for it not this time to oppose any congressional effort to humanize the International Monetary Fund, because now there is an alternative; namely, the setting up of a world development agency and the withering on the vine of an agency that has lost its touch.

Thank you very much for calling these hearings, Mr. Chairman, and I look forward to an interesting session.

Chairman NEAL. Will the chairman yield?

Mr. REUSS. Yes.

Chairman NEAL. Are you suggesting that we just bypass the IMF and cast our lot with this as yet unestablished world development fund?

Mr. REUSS. No. What I am suggesting is that we perhaps direct—that is to say, if we can't get the kind of humanizing amendment which Dr. Cline and I just were discussing into this legislation, people like myself are no longer in the position of saying the IMF is the only game in town, that we might then look toward the phasing out over a period of years of the IMF into the kind of world development fund where cautious, prudent fiscal and monetary probity could be combined, other things being equal, with the kind of humanitarian approach which I know you yourself espouse.

That seems to me the quest we are after here, and I wanted to signal the Treasury that the dialog this year will be in different terms from other years.

Chairman NEAL. Mr. Chairman, if you would yield further. I have come to the conclusion that the way to—I don't know the exact quote from the IMF charter, but the way to promote prosperity and so on is in fact to run an economy in a productive way, a way that can produce wealth for people. I know you are not saying this, but I hear in some of this and in previous concern over the IMF the implicit idea that it is somehow the IMF which must back off these policies of encouraging what I consider to be sensible fiscal and monetary policies, and maybe adopt some other model, that it would be able to solve all of these problems.

And I would just ask the question: Where is that? What is it that would produce more for a country than sensibly run economies? The socialist model sure isn't working.

Mr. REUSS. I will answer the question very quickly. No; I am all for your model and the fiscal and monetary strictures that you and I would impose, they don't vary a hair. Where there is an area for improvement, though, is for the IMF to descend from its macroeconomic high horse, as I put it, and get with the realities.

For example, Dr. Cline in discussing the Peruvian matter pointed out that the IMF had cut down on two things: one, don't import as much gasoline for luxury driving—and Dr. Cline indicates that he approves that. I do, too. I think that is a good thing. Peru also, under the IMF arrangement, was asked to and I guess has cut down on its food subsidies. Well, if that was in fact a requirement, I think that is a bad one.

And I think the kind of analysis that I am describing would enable the IMF, without working overtime, very frankly, or even

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cutting down on its golf games, to take into account the fact that there are good macro and micro policies and bad micro and macro policies; and that the name of the game ought to be fiscal and monetary probity to the queen's taste, but combined with that macroeconomic track which corresponds to basic human needs rather than that microeconomic track that gets all hung up on fixing up banks or seeing that the developing country can afford the Mercedes that it wants.

Chairman NEAL. Those aren't IMF policies, are they, Mr. Chairman? I don't think IMF policy says anything about cutting back on food supplements or wage increases or anything else, or encourages some kind of magnificent living standard on the part of the wealthy.

Mr. REUSS. I gather that the IMF policies in Peru have resulted or are resulting in a diminution of the Peruvian equivalent of food stamps. Is that wrong?

Dr. CLINE. I think the food subsidy issue very nicely illustrates the problem that I was referring to of having an insufficient analysis of the problem. It is true that the food subsidies were cut down. It is also true that the presence of the food subsidies tended to keep prices to farmers lower than they would have been, tended to encourage the import of food rather than the domestic production of food. And it is also true that the urban dwellers by and large are in the upper part of the income distribution. It was the upper part of the income distribution that was primarily benefiting from the urban food subsidies; and that the elimination of the food subsidies very well may have helped the people really at the bottom, the poor farmers.

I think that I would agree with your broader point that the IMF should be looking at these kinds of building blocks as a package and not just at the macro picture. And I think the IMF is doing that.

I would also like to clarify that it is not my impression that at this point in time the IMF considers itself appropriately intervening on these kinds of choices. The new guidelines of March are directed precisely at choices such as that between raising taxes on the one hand and cutting food subsidies on the other. The IMF's present posture, as I understand it, is that they would tend to let the Government decide on that kind of a choice. Professor Williamson could perhaps give us some more detail on this section.

Mr. REUSS. I think your mind, Dr. Cline, and mine are substantially in agreement. But without getting into what has actually been done in Peru or Jamaica or New York or wherever, it certainly doesn't hurt to erect some guidelines and checklists which the IMF bureaucracy ought to have before it when it makes up the stabilization programs.

If it turns out that the retroactive application of those guidelines shows that they have been doing everything right for the last 25 years, great, we will commend them for it. But the trouble is, we don't know. And here, just on the subject of Peru, we find that the analysis of the various witnesses differs.

I would like to have it stated from the IMF just what the impact of the plan will be.

Well, I have taken too much time.

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Chairman NEAL. Thank you, Mr. Chairman.

Mr. Cavanaugh?

Mr. CAVANAUGH. Well, Mr. Chairman, I think your time was well spent. And certainly your suggestions I think would be well for the subcommittee to consider, and I am glad the chairman appeared here today.

And I also want to commend the chairman of the subcommittee for this remarkably stimulating panel and for the participation of each of the panelists. I think that you are one of the most outstanding panels that I have had the opportunity to observe in my service in the Congress, and that you have certainly laid before the record of this Congress a diversity and a complexity that confronts us in developing a public policy to address our role in international economic stability and in international economic justice.

And I think, I hope, that the Congress will inexhaustively use the record that you have created for us today. And I commend the chairman for his imagination in constructing this panel.

Dr. Cline, I guess I find your testimony most challenging. As I go through, I find a number of irreconcilables. You first of all seem to indicate that the IMF policies have been remarkably successful up to now in achieving both stability and equity in those instances in which conditionality has been imposed. Is that a correct reading?

Dr. CLINE. Could you show me what page you are referring to, sir?

Mr. CAVANAUGH. I look for a precise statement of that fact. But for example, you say:

> Despite popular press accounts depicting IMF as an oppressive enforcer of orthodox policies that cause hardship, it would be a mistake to weaken IMF's performance conditions on its loans. To do so would debase the IMF stamp of approval, thereby jeopardizing the Fund's key role in mobilizing much larger resources of the private financial sector.

So that basically what is occurring not only in Peru today, with the record of that performance and the record in general, has been a successful one in your concept?

Dr. CLINE. I think the broad pattern has been one of success. I would not like to say that it would not have been possible to do it better. Professor Williamson has had a long association with the Fund and has given us some very useful and concrete ideas on how it can be improved, and I would associate myself with the pursuit of those ideas.

Mr. CAVANAUGH. Specifically with regards to Peru, you say on page 8 that the economic problems in 1978 imposed extreme economic suffering. Do you find the experiences and analysis of Father Burns here to be exaggerated in terms of the impact on the poor in Peru? The impact has not been extreme, there has not been extreme suffering among the Peruvian people economically?

Dr. CLINE. I think the problem lies in defining what the impact of the program is. To make an assessment of what the impact of the program is, one has in mind an alternative. Yes; I would agree with Father Burns' description of the present situation among the urban poor. The study that I did on Peru pointed out some of the same facts such as the rising share of the budget that is going to food. There is no doubt that this poverty, this suffering, exists.

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The question that we are addressing here is whether this suffering and its overall extent in Peru, not just in the urban areas but in the countryside, would have been less or greater without IMF support, A and B, with some alternative IMF package.

Mr. CAVANAUGH. And your conclusion is, without it at all it would have been more severe?

Dr. CLINE. Yes. In 1978 Peru had basically stopped its external accounts. They were on the verge of default. They couldn't even get short-term bank credit to cover imports.

Mr. CAVANAUGH. And D, that there was no effective alternative that would have lessened the suffering available to the IMF?

Dr. CLINE. I think that is more debatable. It is conceivable that there would have been some alternative that could have meant less immediate suffering. I am not so sure that I would agree with Professor Williamson that the program was too severe. We have two directly competing views here.

Mr. Moffitt thinks that the program was not successful at all, that Peru turned around its economic situation externally solely because of the price increases, which were fortuitous. Professor Williamson thinks that, on the contrary, that much of the turnaround was because of an overly successful and unnecessarily hard program.

I would be doubtful that a much softer program as of 1978 would have achieved a sufficient turnaround. In the context of these hearings and in the context of what has been proposed, what I am saying is that it is extraordinarily difficult to come up with that better alternative. And I find it difficult to believe that a mandate in legislation would provide a major change in our ability to do this, because I don't think the problem is one of lack of will or lack of attention. I think it is a problem of a lack of real alternatives.

Mr. CAVANAUGH. Well, that is where I think I want to go with you, then. And Chairman Reuss alluded to it, and of course the Brandt Commission attempts to address it, as have others in the past. At the time of Witteveen, I recall that Senator Javits proposed an alternative in the Senate, a $20 billion facility.

Is the problem really far broader in terms of the structure in which we are operating, and is the IMF inadequate as presently constituted to provide real meaningful alternatives? Now let me go just a little bit further with you, because I derive a good deal of this from your own testimony, because you say in the case of Peru on page 8 you said:

> If Peru had worked out a stabilization program with the IMF as early as 1975, the program could have been much less severe and the adjustment much less painful. The foreign private banks bear some responsibility because their large lending in 1975 and 1977 made it easier for Peru to delay corrective action. Then, when the crisis became extreme, the banks cut off their lending.

Then on 13 again—I go back to the statement that you make that:

> To infringe upon the IMF's ability to impose conditionality when the situation has deteriorated as bad as it has proved to do so would debase the IMF stamp of approval, thereby jeopardizing the Fund's key role in mobilizing the much larger resources of the private financial sector.

What that says to me is here you have a case of Peru, and of course there are other attending circumstances—commodities and

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the fishing industry and the other economic factors. But certainly one aspect was improvident, imprudent, excessive lending by the banks in the first instance, creating a massive debt burden that had to be borne. Then the IMF comes in, inadequate, incapable of wholly sustaining because of size or substituting itself for this improvident, imprudent borrowing that remains; simply adds to it in order to sustain the system to provide for more borrowing and lending on top of that.

Wouldn't it be better if we had a system that allowed a true alternative, if you had imprudent, unreasonable, excessive borrowing? If the lender and the borrower entered into a bad deal, let them appropriately suffer the consequences of that bad deal and move on. What we have got here is a system that says we must protect a bad deal, we must certainly protect the banks, and that burden then has to be carried by the entire population of the Peruvian people over a protracted period of time, and the only function and role of the international lender is to sustain and protect that system.

Isn't that one portrait of the structural problem that exists?

Dr. CLINE. I think the structural problem on the side of the banks would be ameliorated if it became international practice that if a country gets into trouble and has to have debt rescheduling, then the banks have to have their moneys rescheduled as well.

There has been too much of a presumption that the banks will get their money out on time, and that the IMF, the international financial community, would essentially pick up the tab.

Mr. CAVANAUGH. That is the system that we have now, isn't it, more or less?

Dr. CLINE. Yes, we do have essentially the situation where the banks do not fully incorporate through their own business calculations the inherent risks to their lending because they anticipate that if there is a problem there will be a bailout.

Mr. CAVANAUGH. By "bailout," you mean intervention by the international lending organizations?

Dr. CLINE. Yes. If anyone has their money not paid on time, it won't be the banks, and I do think that if we establish alternative ground rules, perhaps within OECD, or within whatever——

Mr. CAVANAUGH. You know, you are the first reputable witness ever to appear before this subcommittee who has ever said—admitted that honestly.

Dr. CLINE. Thank you for the compliment.

If we could get it accepted that the banks have to internalize the risk, we would have less of this riches-to-rags syndrome. We would have more prudent lending to begin with, and then that would keep countries from having so much rope that they hang themselves, and then they would not get into this problem.

In sum, on that particular point, I think that is where we ought to go.

Mr. CAVANAUGH. Let me put it another way.

We need, I think, to somehow address this structure so that if you have an imprudent bank, and a bad government, that the people of the country—the real parties at interest, and successors at interest, and the international system isn't designed to place upon them interminably the burden of the agreement, the bargain

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entered into between the improvident lender and the excessive, irresponsible, corrupt and certainly nonrepresentative government that may have existed, and may have gotten together at one point in time, and today that is the system, no matter how obnoxious, how self-serving that arrangement, the benefit of it is protected and assured by the international system that we now espouse, and you are here ratifying and defending today.

Dr. CLINE. Well, I would not want to say that I would ratify everything in the status quo. if that is what you are suggesting; no.

I think one of the implications is that there are situations in which——

Mr. CAVANAUGH. But somehow, don't we have to get in and cut that out?

Dr. CLINE. Yes, and I think the way that you cut it out is to accept that in some cases, that reschedulings are necessary; there have to be orderly debt reschedulings.

Mr. CAVANAUGH. And defaults.

Dr. CLINE. Well, I don't think that default is the answer. Default simply means there is a cessation of future lending. If you have orderly rescheduling, then everthing can proceed accordingly, but you are certainly not going to make the poor of Peru better off if you suddenly have default that dries up all future private lending.

Mr. CAVANAUGH. You would if you had an international monetary order that said: in those instances where a bad government and an improvident lender have gotten together, we will intervene and ameliorate that situation without enriching.

If it is an appropriate economic consequence that that loan—that the benefit, the purpose for which the loan was made was economically unrealistic, and economically collapsed, let it collapse, but then direct the ameliorating policies in the international agency, and let those people take their losses.

The international policy should then be to construct an economic program that creates real acceptance of that, and provides for appropriate readjustment of productive economic activity in the country. Let it go on. I mean, that just seems like that is what the system should do.

Dr. CLINE. But it won't work, if what you are proposing is default, because the country would then not be able to get new loans.

It will work if what you are proposing is a fairly sophisticated approach to the phasing out of the debt schedules, a rescheduling of the debt.

Mr. CAVANAUGH. Wouldn't it work if the international agency were of a sufficient size and composed of a disposition to serve a broader public policy interest rather than of indequate size and of a disposition to simply assure and ratify and protect the lenders?

Dr. CLINE. The international agency that is the most cautious of its creditworthiness, of its borrowers, is the World Bank. If the World Bank were confronted with lending tomorrow to a country which had just defaulted on its private debt, I doubt seriously that they would be prepared to do it.

Mr. CAVANAUGH. Mr. Chairman, I know I am taking too much time. I wanted to ask Professor Williamson, just briefly—there is a story here in the Monday Journal. Did you happen to see that?

Mr. WILLIAMSON. No, I didn't see it.

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Mr. CAVANAUGH. Then they quote extensively, apparently an economic analyst in Brazil named Celso Ming. Are you familiar with him?

Mr. WILLIAMSON. I am sorry; what was the name?

Mr. CAVANAUGH. Celso Ming. At any rate, he, analyzing the Brazilian situation, says—and the world situation—he says:

"With service charges on foreign debt chewing up more than half of many countries' export earnings, analyst Ming believes that such a showdown is coming soon, the showdown between all of the borrowers and lenders."

Is he accurate in your understanding, that service charges on foreign debt now chew up more than half of the countries' export earnings?

Mr. WILLIAMSON. I am not familiar with global aggregate figures, but in the Brazilian situation that is correct; yes. This year, interest plus amortization is expected to be something like 60 percent, I guess, of Brazilian export earnings.

However, I think that these figures—they look terrifying at first glance, and I think that they are sufficiently worrying that one ought to be concerned about them, but I don't think they're quite as worrying as the initial impression tends to suggest.

Remember, quite a big chunk is amortization; that is to say that one is essentially rolling over debt and taking new debt to replace old debt, rather than increasing indebtedness. Furthermore, when one has foreign debt of $50 billion, and the dollar itself is being inflated at 10 percent a year, 5 percent of that debt, in real terms, just disappears each year through U.S. inflation. There is therefore a considerable overstatement in these figures.

I don't want to sound complacent, because I think one should worry about these things, but at the same time, initial figures do overstate the size of the problem.

Mr. CAVANAUGH. The major U.S. banks are in too deep to get out; would you agree with that?

Mr. WILLIAMSON. I would agree with that.

Mr. CAVANAUGH. Ming makes a statement here; he quotes a banker—well, I guess he quotes Mr. Ming as saying: "If I owe a million dollars, then I am lost, but if I owe $50 billion, the bankers are lost."

So that is the situation not only in Brazil but many other countries more drastically than Brazil.

Mr. WILLIAMSON. I think there is a lot of truth in that; yes, that it would be very difficult—it would be very unwise to do anything to provoke a default type situation in Brazil, and certainly the Brazilians aren't thinking in terms of provoking that type of situation themselves.

Mr. CAVANAUGH. So that really the situation is out of control from the point of view that the future lending isn't premised upon what would normally be sound lending judgments, but is defensively based upon protecting what has already gone in.

Mr. WILLIAMSON. Well, it is combination of the two; individual banks, after all, could still try and get out what they have in there, if they decided that the situation wasn't viable in the medium term.

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But, I don't myself take a view of the Brazilian situation which suggests that their foreign indebtedness is out of control. I don't think it is out of Brazilians' control; I do think it is true that if they were to start acting unscrupulously, they would have quite a lot of leeway to do that, in view of the extent to which they are already in debt.

Mr. CAVANAUGH. The article goes on to quote a U.S. banking representative, who states that many of the major lenders—banks, U.S. banks—are already approaching their legal limit on loans to Brazil.

Is that your understanding also? Then it makes the point that we will have to get the participation of a second tier of banks, so that now we have the major U.S. banks extended to their legal limit, and yet in order to protect, to their legal limit, and then in order to protect those huge loans that they have at risk, they now must seek to entice a second tier of U.S. banks, smaller banks, into future participation in loans to Brazil.

It that what you foresee?

Mr. WILLIAMSON. I can't say that I had given any thought to that particular possibility. I am a little bit suspicious of the story; you know, we had lots of stories in 1974 about how the banks could never recycle the oil money because of all sorts of rigid limits that they were supposed to have, and it turned out that they had a great deal of flexibility when it came to the point.

Beyond that, there is, again, the counterpart to the U.S. inflation. All U.S. banks are increasing their deposits at 10 or 15 percent a year. And therefore, presumably, their lending potential to each set of borrowers is going up at that rate.

So that even if those limits are there, they are presumably rising year by year, and therefore a substantial chunk of the debt could be financed simply out of the growth in the banking system, without pushing them up any further against those limits.

Now, at the moment, the Brazilians are still increasing their net indebtedness in real terms relative to most other economic aggregates, and therefore that won't completely take care of the problem.

There are other banks, there are other sources of finance; there are foreign bonds and so on.

Mr. CAVANAUGH. But isn't it realistic, in the short term, over the next 5 years, let us say, isn't it reasonable to conclude that the major lenders, those American U.S. financial institutions who have assumed, since 1973–74, the primary recycling function, are now extended in these loans to such an extent that they can't make provident judgments on future lending, but are simply lending on the basis of projecting past extensions?

Mr. WILLIAMSON. Well, I am not quite sure that that would be true of an individual bank. Certainly, if the banks as a whole start to pull out, they would very soon find that this was an unwise policy.

But an individual bank could still reduce its exposure without threatening the system, and as far as I know, there has not been a move in that direction.

Mr. CAVANAUGH. You don't think it is a realistic prospect to think that we will need the participation of other banks of the

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second tier of U.S. banks, in foreign lending? That is not foreseeable?

Mr. WILLIAMSON. I really haven't considered that one. I mean, it is conceivable; I would certainly not like to go on record as saying that I can not conceive of that. But it is not clear to me that that is inevitable.

Mr. CAVANAUGH. You don't know the extent of the extension of the major banks?

Mr. WILLIAMSON. I don't know how close the major banks are up against these limits, nor how firm those limits are. Nor what devices they have for getting around them. It may very well be that they would in effect start passing on some of their loans to second-tier banks, while continuing to do the negotiating themselves.

Chairman NEAL. Will the gentleman yield?

Mr. CAVANAUGH. I would yield to the chairman.

Chairman NEAL. I am intrigued by this question, but I am not following what you might suggest in all this.

Is the suggestion that it might be a healthy thing for there to be mass defaults on loans?

Mr. CAVANAUGH. No, I am not suggesting that at all, Mr. Chairman. I am suggesting that it is the responsibility of this subcommittee, I think, and the full Banking Committee, to attempt to understand the role that our private U.S. banks are playing in the relationship between—in providing that the bulk of the lending for the less-developed countries of the world, and acting as the primary recyclers of the petrodollar surpluses, and to understand the relationship between that role and the role that the public funders that we are considering, and to make a judgment as to whether or not that relationship is one that is stable and reasonable, and to understand whether the role that both the U.S. banks are playing, and that the IMF is playing, is one that is designed to facilitate international stability in the economic system.

And if we don't ask these questions, if we don't inquire into it, I think we are not going to be able to make a sound judgment on this legislation, whether or not this contribution is reasonable and adequate, and whether or not the structure that exists is appropriate.

I would hope that we could. I see that we have only one banker, and when we look at the magnitude of the problem confronting the country we look at the tremendous role that the banks are playing, it seems that we have to consider this: are banks in jeopardy? Is the banking system in jeopardy? Is there a captial outflow problem, as the chairman of the full committee has outlined?

Are we looking at the prospect of involving the second-tier banks in order to sustain the six majors? And to protect their position, and to continue to facilitate the recycling?

Do we need to increase their loan limit authorities?

It just seems to me that we have got to look closer at the banks, not to mention Father Burns' inquiry as to whether or not the banks should ever be asked any questions, if they are lending money, large sums of money, improvidently to nations such as Peru to purchase arms, acquiring tremendous debts for the future burden to be carried by that whole nation's population, and those

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improvident, unreasonable and unjust loans are propped up and sustained and guaranteed by this international lending fund.

We have to go into all of those, and it is one fabric.

Chairman NEAL. But is that the case? Is it the fact?

The picture I am getting from this is that the less-developed countries have that forced on them, this wide range of improvident and imprudent loans, with the idea in mind that if something were to go amiss, then they would be bailed out by the IMF.

Mr. CAVANAUGH. Well, I think that allegation has been made in the testimony before us today, certainly by Father Burns. The only way I know to answer it, we should get Manny Hanny in here. Aren't they the lead in Peru? Get Manufacturers Hanover Trust, get Chase, get Citibank, and ask them what they expect.

Everyone here has testified that the primary function of the IMF is to give its stamp of approval. In fact, "stamp of approval," I think you can find the phrase in almost everybody's testimony. It is like the golden word here.

In order to—you have to add the IMF stamp of approval in order to continue to attract private lending in sufficient quantities, and that is the guts of the issue before us.

As Dr. Cline has so succinctly put it, and as Chairman Reuss has so, I think, eloquently asked it, we have got to have an alternative, don't we?

Father Burns says, how can you say that Peru was free to not go to the IMF, and is free not to accept conditions when it doesn't have a real alternative, and when the IMF's whole game is to create conditions which will assure the lender, who Dr. Cline says was culpable in the first instance in creating the situation that Peru has—but the IMF's sole design now is creating a policy that will guarantee that culpable lender the benefit of his previous bargain and entice him into making continued credits on the basis that his improvident loan was guaranteed by the international lender.

That is a serious question.

Dr. CLINE. Since my reference seems to be being referred to in asserting that the banks have been improvident, let me clarify what I have to say.

One could not say that the bulk of bank loans to the Third World have been imprudent, have been improvident, or were forced upon the Third World.

That would be a vast misrepresentation of the facts.

What one can say is that in a number of isolated cases—Peru, Turkey, Zaire, and others—the banks probably lent more and lent longer than they would have if they had perceived the rules of the game being that they would always have to bear the risk, if there were a default.

Because they perceive the rules of the game as including good probability that the international community would make sure that they would not bear the end-cost of a default, they tended to lend more and to lend more easily than they otherwise would have.

But the vast majority of the loans, I believe, have been good and have been prudent.

But the price at which these loans are going illustrates my point. Despite the fact that people are writing articles such as the one we

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just heard about Brazil, the price that Brazil has been paying for loans is extremely low. It is only about three-fourths of a point of interest above the London interbank overnight rate. Low rates such as these reflect the fact that the banks are not internalizing the full risk.

But I do not want to leave the impression that the result has been an enormous backlog of bad loans. I think that that would be a misrepresentation.

Mr. CAVANAUGH. Well, I am not sure that I want to make—I am not sure that that is the point that I am making, either.

Unquestionably, in 1973 and 1974, circumstances created a situation where you had to have a recycling mechanism. There was both an excessive accumulation of capital among OPEC and an extremely aggravated demand for capital among non-oil-producing nations.

And somehow, you had to accommodate that.

There did not arise, in order to do that, an internationally agreed upon mechanism.

So we have acquired an ad hoc mechanism. But it is an ad hoc mechanism that ostensibly represents to be operating under tried and true historic principles of free competition, the value of the bargain—which it is not. It is a hybrid. And it is a hybrid that, because it wasn't created out of a coherent fabric of thought in terms of what kind of an economic world we were going to live in and what the equities of that world should be, now creates opportunities for very severe injustices and unnecessary injustices, as in the case of which Peru is a prime example, where you protect the bad loan, even nefarious economic relationship, as well as the necessary, as well as the legitimate.

And that is the point that I am trying to say. That is the intolerable corruption that is existing in the system today, and one that we avoid.

It is unpleasant, on the one hand, and it is unprofitable on the other, among those most capable of understanding it.

Mr. MOFFITT. First of all, let me say that I might take issue with Representative Cavanaugh's suggestion that Dr. Cline was the first reputable witness before this panel to say that the IMF was bailing out the banks.

Mr. CAVANAUGH. I do retract that. You were the second.

Mr. MOFFITT. I would like to clarify the issues. I do not think anyone agrees with the suggestion that we don't need an international institution to provide support for what economists call the international adjustment process.

I also don't think that anyone disagrees with the concept of conditionality. I mean, you couldn't have an institution which simply hands out money to any sovereign state that happens to come along.

What I would maintain is that, as Chairman Reuss and Representative Cavanaugh mentioned, we have been forced to choose between supporting the Fund whole hog and all that that entails, or into the position that we don't think there needs to be an international institution to perform some of the functions which, at Bretton Woods, the Fund was supposed to perform.

I would argue that it is not really performing those functions today.

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It seems to me that one of the reasons we have been forced into the short-term mentality is precisely because when the OPEC countries started pouring these petrodollars into the banks, every bank which was competing for the deposits of every shiekdom had to find new outlets. We had a recession beginning here, so loan demand was down. The Third World needed the liquidity to finance the problems which everyone has referred to.

It seems to me that the banks might have thought twice about certain kinds of loans had they alone been forced to bear the risk if those loans went sour.

The reason you get these horror stories like Peru is simply that these countries are forced to undertake adjustment in no more than 3 years.

I think that is much too short.

I mean look at the years that we have been grappling with trying to reduce our oil imports. No one would suggest that we could have done that in 3 years, an economy as big and powerful and diversified as ours.

Mr. CAVANAUGH. If I might just interrupt you here because Secretary Solomon and everyone else who defends the existing system is almost beyond any substantial question, always says to us, what if these conditions were imposed on the United States?

We would rebel against them.

Well, of course, we would. We would rebel against the existing conditions because they are economically unsound.

Mr. MOFFITT. Exactly. I might also add, in slight contrast to Dr. Cline, that while some urban wageworkers might be found in the upper half of a country's income distribution, let the International Monetary Fund say to the United States that certain benefits which may have accrued to AFL–CIO members be eliminated because they are fiscally irresponsible and find out how long the Congress or the administration can put up with the flack from an organized labor movement.

It seems to me that we simply must extend the time for these programs. We also have to talk about new criteria, basic needs criteria.

And the fact of the matter is we have to get more data from the banks. I mean, every time one of the bankers comes down here and you ask, how much have you loaned to this country or that country, they will say: It will damage our competitive position if we tell you that.

The fact is that the syndicated Eurocurrency loan market, according to Walter Robichek, the head of the IMF's Western Hemisphere Division, has some of the aspects of a cartel.

I mean, in the case of Peru, you have got 280 banks participating in the consortium. And the country is forced to choose either between this abyss of default or an extreme adjustment program.

I think we should begin to look for some alternatives between those two choices.

Mr. CAVANAUGH. You carry a debt that was a bad bargain in the first place.

Mr. MOFFITT. Occasionally, one can get a look at these IMF stabilization arrangements. In the ones that I have studied, I have

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yet to see references to imprudent or improper or excessive lending by the private multinational banks.

The whole burden is thrown on the public sector of the deficit country, as the one that is responsible. All of the burden of adjustment is borne internally.

I think that that has to change.

Chairman NEAL. Professor Williamson, you have worked with the Fund, as I understand it, for some time. Could you give us some idea in general terms of how the Fund deals with these questions of human need?

Mr. WILLIAMSON. I do not really think I can add anything on that. The 2 years I spent in the Fund were some time ago, and I wasn't working on this type of problem. I wasn't, in fact, dealing with stabilization programs at all.

Mr. CAVANAUGH. Could you go on the other side of that, though, and address yourself to Mr. Moffitt's question of how the Fund addresses improvident lending by the banks?

Mr. WILLIAMSON. Well, that is the problem. The obvious example of improvident lending by the banks is, I think, the Peruvian case. And I have not had any more access to Fund documents on Peru than anyone else here. So I can't confirm or deny that.

Could I just make one general observation on this discussion?

I think there is a lot to be said in principle for the view that has been expressed, that the banks should be expected to carry the consequences and, if they make improvident loans, that they should take the consequences.

And in an ideal world, I am sure that one could build that into the system. But I do have some reservations about what would happen if one simply superimposed that requirement on top of the existing system without doing anything additional to facilitate the flow of finance to Third World countries.

Mr. CAVANAUGH. I would never suggest that and I have not suggested, and I could not do it.

But that does not mean that we can either afford to continue to ratify improvident loans previously made in perpetuity. Or to continue to sustain a system that not only ratifies past improvidence, but encourages all future improvidence.

I would like to ask, just in closing Mr. Chairman, I know we have gone far beyond where we should—if either Mr. Williamson or Dr. Cline feel that there is a role and a responsibility for the IMF to evaluate private lending practices and to pass some judgment on it in terms of their own participation in a country readjustment situation?

Mr. WILLIAMSON. I, in fact, in the past have argued that the Fund should make an attempt to develop explicit targets for current account balances of individual member countries.

If that were to done, it would seem to me natural to use those targets as a basis for starting to say that lending to a country which continually and systematically had a deficit in excess of the target which was internationally agreed might be regarded as internationally irresponsible.

I think one could develop mechanisms of this sort. But at the moment, we don't have the necessary basis, in my view.

Chairman NEAL. Father Burns, you wanted to make a comment?

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Father BURNS. Yes. I am sorry, I apologize to the Chair for taking so much time previously, but I have two short comments.

One, with regard to the banks forcing the country to take loans, as you mentioned, Mr. Chairman, I think a case can be made for that in a situation like Peru. The Government was politically unstable at the time. If it went to the Fund at that particular time, it would probably have fallen.

The people of Peru were not at all in agreement with the Government, and if the Fund's policies were imposed or agreed to, the Government would have probably fallen at that time.

That was a judgment. So the only alternative that the Government had at the time was to receive that loan from the banks. in a broader sense of the word, a nonrepresentative government imposed these loans, by accepting them on the people and the people had no alternative. They were't consulted. They had no possibility to say yes or no.

One final comment. I think it is very important with regard to human needs and the International Monetary Fund—somebody can correct me on this—but in my study of the data, the International Monetary Fund data books, I see no criteria, despite employment being their No. 1 primary commitment, I see no criteria or even data on employment situations in a country—I see no data on real buying power. There is a consumer price index, but that is it.

The only other human factor that is taken into account is population, how any people live in the country.

It seems to me that it is very difficult to move toward this first article and its completion if you do not even have the data available when you are doing the studies.

Chairman NEAL. Well, I think that several witnesses have indicated that. It is the theory of the Fund that market principles will produce more wealth than will some other model. And so those assumptions, I assume, are implicit in what the Fund does. Now that is subject to debate, clearly, and the debate goes on.

I have been looking at this for several years and it just seems to me that we don't live in a perfect world and that if we had the opportunity to do exactly what we want, there are many things that we could do.

I am not saying that we can't improve. There obviously are some ways we could improve this.

But in going through this once before, when we were considering the Witteveen special facility, there were a number of attempts to make the Fund into something that it was not.

The analogy that made some sense to me at the time was that we had a pickup truck doing a very specific and very critically important job in this world and we were trying to load it, we were trying to get it to carry the load of a moving van or a tractor trailer rig or something, and it simply can't do it.

If we attempt to load this instrument down too much with baggage it can't accommodate, we will destroy the effectiveness of this vitally important institution.

You disagreed with me when I said that I thought that Peru needed more aid. But I reiterate that. I think that that is precisely what a country that is in the shape of Peru needs.

It needs aid, it needs some help, with little or no strings.

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But the IMF is not in a position of granting aid. It is not an aid-granting mechanism.

Father BURNS. Peru would not be in the situation we are in right now so drastically if it were not for the banks and the IMF short-term program.

Peru is receiving aid. The United States has increased their aid, and so forth. It burdens the American taxpayer even more.

I don't think that is—I mean, in that sense, I don't think of aid as a kind of a band-aid operation which you pull out when you can get to the cause of it—the "solution" exacerbates the problem.

Chairman NEAL. That is very fascinating. What is the cause? That is what I was trying to get at earlier. Is it the IMF programs that the Peruvian Government agreed to? Or is it in fact the previous policies of the Peruvian Government and some other very unfortunate circumstances like the anchovies not running and so on.

Father BURNS. To me, and again, not being an economist, it seems to me from what has been said today, that there are an awful lot of contributing causes.

I would put it this way. The policy of the IMF agreed to by the Peruvian Government has exacerbated an already bad situation.

Chairman NEAL. More than if there were no IMF there?

Father BURNS. More than if there were a better alternative to the IMF.

Chairman NEAL. But that is the question. Is there? We don't live in a perfect world. What is that alternative?

Father BURNS. I am not addressing the past history. I am addressing the future. Something new has to be created.

Chairman NEAL. But that new thing, would it be more like an aid agency?

Father BURNS. What I am saying is, and I say in my testimony that I support the observations of the witnesses here today who speak to the question of longer term conditionality which takes into account the question of human needs, a solution which is not so drastic—also the fact I think the austerity program should be borne also by the banks when they make imprudent loans.

I agree with that totally. I think those criteria have come out very much in this.

I am not looking for another aid institution. People of Peru are working people. They want to work. I don't look for a financial institution that takes work away from them, either. I don't want my people to be beggars. They don't want to be beggars.

Chairman NEAL. Well, I don't mean to fuss with you because I admire more than I can tell you what you are doing and your concerns, and I share those concerns.

It is trying to find sensible answers, though, that I think is most important for us on this subcommittee. And, frankly, that is not always easy. Some of the things that look real good for the short term may be just that. It is great for the short term, but they do not make sense for the long term.

Anyway, we will keep working with it and I would like to thank all of the witnesses again for coming today. You have been most helpful.

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If you have any additional thoughts on this or any other subject that we deal with, please feel free to let us have your advice at any time.

Mr. CAVANAUGH Mr. Chairman, I would just like to express my appreciation to you. And as you have stated, we have not arrived at perfection. But I do think that your efforts in constructing this hearing today will certainly go a long way. And your efforts in the past, because I have served on this subcommittee.

I think that, as you say Secretary Solomon testify, that the input of the Congress has been significant in terms of refashioning our Nation's approach to the international economic difficulties that beset the world.

You have played a leading role in that, I think, by your willingness to open up this Congress and to open up the country to a full and exhaustive exploration of the complexity and the difficulties that beset us.

The results have been progressive. I think that you are to be commended for that, and you certainly have my appreciation for the contribution that you have made to improving our international economic situation.

Chairman NEAL. Thank you. And I would like to thank you for all of your hard work and help.

Often, it would just be Mr. Cavanaugh and I, maybe another person or two at these hearings. I appreciate your work and I am sorry you are leaving the Congress.

Thank you all very much. Thank you for coming.

[Whereupon, at 1:10 p.m., the hearing adjourned to reconvene at 10 a.m. on Thursday, February 7, 1980.]

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TO AMEND THE BRETTON WOODS AGREEMENTS ACT TO AUTHORIZE CONSENT TO AN INCREASE IN THE U.S. QUOTA IN THE INTERNATIONAL MONETARY FUND

THURSDAY, FEBRUARY 7, 1980

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON INTERNATIONAL TRADE,
INVESTMENT, AND MONETARY POLICY,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, D.C.

The subcommittee met 10:10 a.m., in room 2128 of the Rayburn House Office Building, Hon. Stephen L. Neal (chairman of the subcommittee) presiding.

Present: Representatives Neal, AuCoin, Cavanaugh, Evans of Indiana, and Hansen.

Chairman NEAL. The subcommittee will come to order.

This is the third day of our scheduled hearings on a proposed increase in the quota of the United States in the the International Monetary Fund. Yesterday, we heard some very important testimony about the impact of IMF stabilization programs on developing economies.

Before we begin today's hearing, I would like to summarize that problem, as I can see it from here.

Several amendments to the legislation before us have been suggested. Their purpose is to modify IMF stabilization programs to take into consideration the possible impact of those programs on the welfare of the poor.

This is a perplexing problem, not because of any doubt about the merit of the goal, but because there is no easy, straightforward way to achieve it.

No one has proposed a very persuasive alternative to the general approach the Fund now takes. In my view, the types of reforms that are being suggested fall into two general categories.

One line of thinking holds that the IMF should continue to propose broad macroeconomic targets for a debtor government to meet in order to correct its balance-of-payments deficit.

But the schedule for attainment of those targets should, in some cases, be considerably relaxed. The targets should be less ambitious, the period of adjustment should be stretched out, and the credit to finance deficits during this more gradual adjustment should be more generous.

The second line of criticism holds that the IMF should begin to place considerable emphasis on specific types of policies within the broad macroeconomic goals to try to insure that economic stabiliza-

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tion programs also promote an equitable distribution of income, relieve the poverty of the poorest, and guarantee the satisfaction of basic human needs.

For example, the Fund would not only recommend a gradual reduction in Government budget deficits, but would also insist that it be done in harmony with programs that promote these social goals.

There is likely to remain, even with the best effort to resolve it, an inherent conflict between these social objectives and the more orthodox objective of correcting a severe deficit of the balance of payments.

If these objectives cannot be satisfactorily reconciled, it is clear that many of the critics of the IMF would give the highest priority to the social objectives at the expense of balance-of-payments adjustments.

In principle, their arguments are compelling; in practice, they imply the need for a ready source of large-scale, long-term aid to finance a country's deficits as long as required.

Realistically, there is no prospect that aid on such a scale would ever be available, nor would it be desirable since every country should, in the long run, earn its own way in the world economy.

So we are forced back to hard choices, rendered all the more difficult by simple ignorance. As one of our witnesses testified yesterday, it is exceedingly difficult to reach firm conclusions about the impact of an economic stabilization program on income distribution.

I have asked our witnesses today for their views on the appropriate role of IMF conditionality. I have also asked them to address other issues that arise in conjunction with this legislation, in particular, the role that the IMF should play in dealing with the problems caused by the huge OPEC surpluses over the next few years and the problems confronting the international banking system.

Our witnesses this morning are Harold van B. Cleveland, vice president of Citibank; Prof. Robert Dunn, George Washington University; Helen Junz, vice president, First National Bank of Chicago; and Prof. J. Carter Murphy of Southern Methodist University.

I would like to welcome our witnesses this morning. We have arranged you in alphabetical order and would like for you to proceed in that order, if you don't mind. Please feel free to give us your entire testimony, which we will place in the record.

Without objection, all testimony so given will be placed in the record, and feel free to summarize, if you would like. That will give us a little bit more time for the question and answer period.

Welcome, and Mr. Cleveland, we would like to hear from you at this time.

STATEMENT OF HAROLD VAN B. CLEVELAND, VICE PRESIDENT, CITIBANK

Mr. CLEVELAND. Thank you, Mr. Chairman, and subcommittee members.

I am very grateful for this chance to present some personal views on the bill, H.R. 5970, and on some of the questions which the chairman raised in his letter of January 18.

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I support the quota increase and, of course, the bill. I do so on the assumption that the money would be available to back up stabilization programs in member countries in accordance with the Fund's traditional policy, that is, the policy of conditionality.

In my opinion, it is truly essential to maintain a clear distinction between that role, the Fund's role, so-conceived as the role of a lender of last resort, and other roles that the Fund might play and, to some extent, has played, such as that of a development bank or a dispenser of aid on concessional terms.

The lender of last resort concept is drawn from central banking. As the subcommittee is aware, in the last century there emerged in England and in Europe the view that a central bank is responsible for the solvency of banks whose assets are generally sound, but which are nevertheless threatened with failure as a result of a loss of confidence.

In these circumstances, the unalloyed discipline of the marketplace could be too harsh for the public good because a panic might ensue, or might be in course, in which some banks would be dragged down with serious deflationary consequences.

So the centeral bank's responsibility, as it has emerged in history, is to lend freely in such circumstances to sound banks which are threatened with those conditions.

By this view, the emergency or last resort lending should not be at the central bank's normal discount rate; rather, a higher or penalty rate should be charged to discourage resort to this facility, except in a genuine emergency. And, of course, to induce corrective steps by banks to the extent that that may be necessary. As I am sure the subcommittee is aware, the doctrine received classic expression in Walter Bagehot's "Lombard Street" in the last century.

Now, the analogy here to the IMF's traditional role—of course, it is an analogy and not an exact parallel—is clear. The IMF customarily lends to countries that are in severe payments trouble when their ability to borrow to finance their payments problems is impaired to the point where they are threatened with a drastic decline in income or employment. But to lend freely without conditions—and the conditions, I might point out, are the moral equivalent of a penalty interest rate—would prolong and even intensify the country's basic problem; that problem being that spending by its residents exceeds available resources by a wide margin.

Conditions intended to assist the Government to bring spending back into line resources through normal macroeconomic means, monetary and fiscal restraint, and an equilibrium exchange rate, are, therefore, essential.

The system—that is, the international financial system—needs an institution that performs this function, the function which is a combination of financial insurance and political discipline.

If the clarity of the IMF's lender of last resort is blurred by mixing it up with other kinds of financial intermediation or with aid, there may be a serious loss of financial discipline.

Lenders and borrowers may come to feel that the IMF will always come to their rescue, and so may be led to take risks they should not take, or to demand insufficient risk premiums in the rates they charge. Perhaps this particular danger is not wholly avoidable, considering the composition of the Fund's membership.

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But it ought to be resisted in the interest of preserving that financial discipline on borrowers and on lenders alike.

If this role is taken seriously, if the IMF is confined to this role, what is the proper measure of its need for resources?

Clearly, I think they must be ample, for the purpose of the resources is to reassure the world community that no member country will suffer an economic or political catastrophe simply for lack of temporary international liquidity.

So the proper measure, I think, is not the use that has been made of Fund credit in the past, nor is it the normal, exceptable amount of Fund drawings that appears to be likely in the future.

For a lender of last resort must be prepared not just for the statistically probable emergency, but for an improbable but still possible crisis in which the scale of financing might greatly exceed any reasonable forecast.

We live in the kind of world where massive improbable traumas, economic traumas, seem to happen. No one foresaw the oil price shock of 1974 or the depth of the ensuing world recession, or the Iranian revolution, or the second oil price shock.

In a world of this kind, it would be unwise to deny the IMF the resources that may appear ample, or even generous, based on past use of IMF funds.

These resources, held in reserve by the IMF, are not in themselves troublesome. They are not inflationary, nor subversive of market discipline. But they do serve to underpin confidence in the stability of the system itself.

Let me come, then, to the so-called petrodollar recycling issue, which I prefer to call the problem of financing the payments deficits on current account of developing countries in the face of rising oil prices and other disturbing influences.

As you know, it is primarily an LDC problem, for most of the advanced industrial countries have absorbed oil price hikes without heavy external borrowing.

Among the LDC's, the payments financing or debt problem is largely confined to countries with a credit standing high enough to make substantial private borrowing possible.

And it is, of course, primarily this group that people mean when they speak of an LDC debt problem.

Right now, as the subcommittee knows, people are asking whether, given the debts these countries have already incurred, private banks will be able to respond to additional needs for balance-of-payments financing in 1980 and afterward.

I would like to put some perspective on this issue and perhaps to answer the question at least indirectly by taking you back a few years—in fact, to 1972—before the first oil shock, and to review with you very briefly the debt buildup and its causes.

To follow the discussion, subcommittee members may wish to refer to the tables at the back of my prepared statement, which pull together data for 11 major LDC's that are not members of OPEC.

These 11 countries account for three-quarters of all private debt outstanding to all LDC's.

Look first at table 1, the fifth line, the current account deficit of these combined countries, which measures, as you know, the excess

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of imports over exports of goods and services that was financed in the past, or will probably be financed in the future.

Before the oil shock—that is, in 1972—the deficit amounted to a bit less than 2 percent of these countries' combined GNP. And I would take this sort of ratio, a ratio in this order of magnitude, as the normal situation of a successful developing country before the oil shock.

For these countries imported capital, in order to speed their development and the capital inflow, of course, permitted a higher domestic investment and growth, and thus, added to the countries' ability to repay at the same time as it increased their external debt.

However, 1974 and 1975 were scarcely normal years. Between 1972 and 1975, the 11 countries' oil import bill rose by $5 billion.

That shows on the table on line 4. And at the same time, their current account deficit worsened by about $17 billion. So the oil price rise accounted for about a third of the deterioration and the remainder of the deterioration was due mainly to the long and deep recession in the industrial world. To finance this deficit, the countries drew on their reserves. That shows in table 3, line 1, and stepped up their foreign borrowing.

Their long-term debt rose from $21.9 billion at the end of 1973 to $47.6 billion at the end of 1975, which shows in table 1, the sixth line. The short-term borrowing also increased sharply, and as a result of the increase in long-term debt, the ratio of long-term debt to gross national product, and of long-term debt service to exports, also rose sharply in 1974 and 1975.

These two ratios I take to be the best rough indicators of the burden of debt, for they indicate in a broad way what proportion of debtor countries' total resources—that is GNP—and of foreign exchange earnings, exports of goods and services, is mortgaged, so to speak, to foreign creditors.

The sharp rise in these ratios in 1974–75 shows that a substantial part of the borrowing that occurred in that period was used to cushion the impact of the oil shock and the recession on domestic consumption, rather than to increase domestic investment.

This was appropriate and probably unavoidable in the circumstances. But, of course, the result was to increase debt relative to the capacity to service it.

In the 3 following years—that is 1976 to 1978—we see a marked improvement in the economic fundamentals for these countries. Their combined current account deficit declined absolutely in nominal terms and even more, of course, in real terms, which shows on table 1, line 5.

Net long-term debt continued to rise rather rapidly in 1976 to 1978, but a large part of this phenomenon was due to the refinancing of short-term debt acquired in 1974–75 as interest rates in the Eurocurrency market declined, particularly in 1977.

Thus, the years 1976–78 saw fundamental improvement in the 11 countries' foreign debt positions. Short-term debt was converted to long-term debt. Long-term debt was refinanced to a considerable extent at lower rates, and net new borrowing, both short and long, declined.

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The decline in net new borrowing shows up in the marked decline of their combined current account deficit, absolutely and also relative to GNP.

By this indicator—that is, the ratio of current account deficit to GNP—the 11 countries regained in 1977-78 their normal rate of foreign borrowing, the normal current rate of foreign borrowing. That is based on the pre-1973 experience. Though, in the meantime, of course, the accumulated debt burden had approximately doubled, measured relative to gross national product.

And so matters stood on the eve of second oil shock. Now the 2 years, 1979, 1980, have, of course, a lot in common with 1974-75. In both periods, a steep rise in oil prices and a slowdown in industrial economies has affected or will affect the LDC's payment position and borrowing requirements adversely.

However, both factors—that is, both adverse changes, oil price and recession, or slowdown—are proportionately a good deal less in their effect on these countries than was true in 1974-75.

As everyone knows, the first oil shock was a 300-percent increase in less than 12 months. The second oil shock was about 130 percent spread over 2 years.

Moreover, the economic slowdown in the industrial world is much milder this time, appears to be much milder this time, and is much less of a surprise than it was the last time.

So, our estimate of the consequences of these new adverse effects for these countries are seen in the tables. The current accounts deficit widens, again, but only to 3.1 percent of the GNP in 1979 and 1980, as compared with 5.9 percent in 1975. And we project only a moderate increase in the ratio of a long-term debt to GNP.

The ratio of these countries' long-term debt service to their exports is actually projected to decline in 1980. It is interesting and important, I think, to observe that this ratio, that is, the ratio of long-term debt service to exports, will not be a great deal higher in 1980 than it was back in 1972 and 1973, before all the trouble began.

The reason is that these countries' exports and their capacity to service foreign debt have expanded enormously in the interim. In fact, the exports have grown a good deal faster than the gross national product, so that these countries' ability to transfer resources abroad, to service debt, have been correspondingly enlarged. This is, I think, a crucial point, not sufficiently noticed in making judgments about the debt position of LDC's.

So I would sum this up perhaps a little impressionistically, by saying that the debt situation of the main LDC borrowers, these 11 countries, appears in prospect in the next 2 years, at any rate, to be manageable.

Looking somewhat further ahead, and perhaps that is really the interesting question—it certainly is the interesting question if I am correct that the debt situation as of today and tomorrow is manageable—but the critical questions remain, of course, oil prices and economic growth in the leading industrial countries.

As we have seen, higher oil prices and growth slowdowns or recessions in industrial countries tend to raise LDC debt and debt service relative to the domestic and foreign exchange resources available to service it; that is, relative to GNP and to exports. This

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occurs because such external shocks lead to surges in borrowing to cushion the impact on consumption.

So, much depends on whether the price of oil rises suddenly or gradually, and whether future slowdowns in the industrial world are severe or mild. If the real price of oil rises modestly and gradually, and if future growth slowdowns are moderate, as the present one appears to be, borrowing to cushion such shocks will be less. And in these circumstances, LDC debt would rise only moderately, and possibly not at all relative to the borrowing countries' capacity to service it.

Now, on economic grounds, there is reason, I think, to hope that future advances in the price of oil will, in fact, be moderate and gradual. Relative to world GNP, energy consumption is declining markedly. Also, world GNP has been, and will probably continue, to grow a great deal more slowly than in the 1960's, mainly owing to stagflation in the United States and Western Europe.

So if the world is spared another political breakdown in the major oil exporting country, and another war in the Middle East, large oil price shocks may be avoided, and likewise, future recessions as severe as the 1974–75 episode seem relatively unlikely. Stagflation seems to mean slow growth, but also relatively steady growth, at least as compared with the early 1970's.

So in sum, there are reasonable grounds for expecting the debt burden of the developing countries that do most of the borrowing to remain manageable. Private lenders, however, are not likely to forget the Middle East war and the Iranian revolution. They may be expected to build that memory into their portfolio policies and the interest rates they charge.

And for its part, the IMF must also be prepared with ample resources for the eventuality that things might turn out a good deal worse than expected.

Thank you, Mr. Chairman.

[Mr. Cleveland's prepared statement follows:]

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Statement of Harold van B. Cleveland

Vice President, Citibank

Mr. Chairman and members of the Subcommittee, my name is Harold Cleveland. I am Vice President at Citibank, New York, in charge of international economics. I am grateful for this opportunity to present some personal views on HR 5970 and on some of the questions raised in the Chairman's letter of January 18, 1980.

I support the IMF quota increase and the Bill. I do so on the assumption that the money would be available to back up stabilization programs in IMF member countries in accordance with the Fund's traditional policy of "conditionality." It is essential to maintain a clear distinction between the Fund's role, so conceived — the role of lender of last resort — and other roles the Fund might play, and to some extent has played, such as that of development bank or dispenser of development aid on concessional terms.

The IMF's Role The concept of lender of last resort is drawn from central banking. In the last century there emerged in England and in Europe the view that a central bank is responsible for the solvency of banks whose assets are generally sound but which are threatened with failure as the result of a loss of confidence by depositors. In these circumstances, the unalloyed discipline of the market could be too harsh for the good of the banking system and the general economy. A panic might ensue in which sound banks would be dragged down, causing a depression. Therefore the central bank's responsibility is to lend freely to sound banks threatened with a run by depositors.

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According to this view, emergency or last resort lending should not be at the central bank's normal discount rate. A higher or penalty rate should be charged to discourage use of this facility except in a genuine emergency and also to induce borrowing banks to take whatever steps are needed to put their houses in order and reassure their depositors. This doctrine received its classic expression in Walter Bagehot's Lombard Street, first published in 1879.

The analogy to the IMF's traditional role is clear. The IMF customarily lends to countries in severe balance-of-payments trouble whose ability to borrow privately abroad is impaired to the point where they are threatened with a drastic decline in domestic income and employment. To allow this to happen would have serious economic and political consequences. But to lend freely without conditions — the conditions are the moral equivalent of a penalty interest rate — would prolong and even intensify the country's basic problem, which is that spending by its residents exceeds available resources by a wide margin. Conditions that assist the borrowing government to bring spending back into line with resources, through monetary and fiscal restraint and an equilibrium exchange rate, are therefore necessary.

The international financial system needs an institution to perform this function, which is a combination of financial insurance and political discipline. If the clarity of the IMF's lender-of-last-resort role is blurred by mixing it up with other

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kinds of financial intermediation or aid, there may be a serious loss of financial discipline. Lenders and borrowers may come to feel that the IMF will always come to their rescue and so may be led to take risks they should not take — or to demand inadequate risk premiums. Perhaps this danger is not entirely avoidable, considering the composition of the Fund's membership. The Fund may at times be forced to assume tasks that are inconsistent with its central mandate; for example, the Compensatory Financing Facility, the Trust Fund and the temporary Oil Facility. But this tendency ought to be resisted in the interest of preserving market discipline on borrowers and lenders alike.

If the IMF is to be confined as far as possible to a lender-of-last-resort role, what resources does it need? Clearly these resources must be ample, for their purpose is to reassure the world community that no member country will suffer an economic or political catastrophe simply for temporary lack of international liquidity. The proper measure of this need is not the use that has been made of Fund credit in the past. Nor is it the normal, expectable amount of Fund drawings that appears to be likely in the future. A lender of last resort must be prepared not just for the statistically probable emergency but for the possible crisis, in which the scale of financing needed might greatly exceed a reasonable forecast.

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We live in a world where massive, improbable economic traumas have happened with increasing frequency. No one foresaw the oil-price shock of 1974, the depth of the ensuing world recession, the Iranian Revolution or the second oil-price shock of 1979-80. In this kind of world it would be unwise to deny the IMF resources that may appear ample, even generous, based on past use of IMF credit. Resources that the IMF holds in reserve are neither inflationary nor subversive of financial market discipline. They serve to underpin the confidence of creditors and debtors and of the general public in the financial system.

Financing Developing Countries' Deficits

The Subcommittee is generally familiar with the petrodollar recycling problem. From the perspective of an international lender, this problem is one of financing the payments deficits on current account of developing countries (LDCs) in the face of rising oil prices and other disturbing factors. Although every net oil importer's wealth is diminished by these sudden shifts in oil prices, most of the advanced industrial countries have absorbed oil-price hikes without heavy external borrowing. In cases where industrial countries have borrowed heavily (Italy and Sweden, for example) to cushion the oil-price shock, they have not taxed their borrowing capacity to the same extent as some LDCs.

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Among LDCs, the payments-financing or debt problem is largely confined to countries with income levels, growth rates and credit standing high enough to make substantial private borrowing possible. It is primarily this group that people mean when they speak of an LDC-debt problem. Right now, as the subcommittee knows, people are asking whether, given the debts these countries have already incurred, private banks will be able to respond to their additional needs for balance-of-payments financing in 1980 and beyond.

To gain perspective on this question I should like to take you back to 1972, before the first oil shock, and review briefly the subsequent debt buildup and its causes. To follow the discussion the Committee may wish to refer to Tables I, II, & III on the back of my written statement. These tables pull together figures for eleven major LDCs that are not members of the Organization of Petroleum Exporting Countries (OPEC). These eleven countries account for three quarters of all private bank debt outstanding to all LDCs.

Look first at the evolution of these countries' combined current account deficit (Table I, line 5). This figure measures the excess of imports over exports of goods and services that was financed, or will probably be financed, in the years 1972 to 1981. In 1972 before the first oil shock, the deficit amounted to a bit less than 2% of these countries' combined GDP. (Table II, line 1). This ratio may be taken as the normal

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situation of the more successful LDCs before the oil shocks. They imported capital in order to speed their development. The capital inflow, reflected in this normal current account deficit, supplemented the countries' domestic savings. It permitted a higher level of domestic investment and more economic growth than would have occurred without it. Thus, as the country's external indebtedness was increased, its capacity to repay was enhanced. In principle, there is no reason a country cannot go on indefinitely adding to its enternal debt, so long as the additional domestic investment, made possible by the borrowing, earns a rate of return that is at least as high as the interest rate payable on the debt. This is the normal situation of a successful private firm — and of a successful developing economy.

However, 1974 and 1975 were not normal years. Between 1972 and 1975 the 11 LDCs' net oil-import bill rose by $5.3 billion (Table I, line 4). At the same time, their current account deficit worsened by $17.3 billion. So the oil-price rise accounted for a bit less than a third of the deterioration. The other two-thirds was due to other causes — mainly, the deep, prolonged recession in the United States, Europe and Japan that cut the prices and held down the volume of LDC exports.

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To finance this deficit, the 11 LDCs drew upon their international reserves to some extent (Table III, line 1), and stepped up their foreign borrowing. Their long-term debt rose from $21.9 billion at the end of 1972 to $47.6 billion at the end of 1975 (Table I, line 6), and their short-term borrowing also increased sharply (Table III, line 4). As a result, the ratio of their long-term debt to GDP, and of their long-term debt service to exports also rose sharply by 1975 (Table II, lines 2 and 4). These two ratios are rough indicators of debt burden. They indicate in a broad way what proportion of the debtor countries' flow of total resources and of foreign exchange earnings is mortgaged, so to speak, to foreign creditors. The sharp rise in these ratios in 1974 and 1975 shows that a substantial part of this borrowing was used to cushion the impact of the oil shock and the recession on consumption, rather than to increase domestic investment. In the circumstances, this was appropriate and largely unavoidable. But the result was to cause some increase in LDC indebtedness relative to the capacity to service it.

In the three years following, 1976-78, we may note a marked improvement in economic fundamentals. The 11 countries' combined current account deficit declined absolutely (Table I, line 5). Net long-term debt continued to rise rapidly, both absolutely (Table I, line 6) and relative to GDP (Table II, line 2).

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But a large part of this rise in long-term debt reflected the refinancing of short-term debt acquired in 1974-75, as interest rates in the Eurocurrency market declined in 1977 and 1978. Repayment of short-term debt in 1977-78 shows up in Table III, line 4.

Similarly, the rise in the 11 countries' long-term debt service relative to their exports in 1977 and 1978 (Table II, line 4) reflects this refinancing. It also reflects a bunching of long-term debt repayments in 1977 and 1978 (Table I, line 9) caused by refinancing of long-term debt to take advantage of falling interest rates.

Thus the years 1976-78 saw a fundamental improvement in the eleven countries' foreign debt position. Short-term debt was converted into long-term debt. Long-term debt was refinanced at lower rates. And net new borrowing, both short and long, declined. There was also a marked decline of their combined current account deficit relative to GDP (Table II, line 1). By this indicator, the 11 countries regained in 1977-78 their normal rate of foreign borrowing, based on pre-1973 experience. In the meantime, however, their accumulated debt burden, measured by the ratio of long-term debt to GDP, had approximately doubled (Table II, line 2).

This is where matters stood on the eve of the second oil shock. The years 1979-80 have a good deal in common with 1974-75. Both periods are characterized by a steep rise in oil prices, and a slowdown in the industrial economies that

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affects LDCs' exports adversely. In both respects, however, the impact on LDCs' current account deficits and borrowing requirements will be proportionately less in 1979-80 than it was in 1974-75. This time around, the oil-price rise is about 120% spread over the two years (Table II, last line). In 1973-74 it was 300% in less than 12 months. Moreover, this time the economic slowdown in the industrial countries is much milder, and not as surprising. Also, this time around people don't expect the price of oil to fall. So, LDC's adjustment will be quicker this time and their borrowing to cushion the impact of the oil shock and slowdown on domestic employment and consumption will be proportionately less.

Our estimate of the consequences for the 11 LDCs may be seen in Tables I and II. The current account deficit widens but only to about 3.1% of GDP in 1979 and 1980 as compared with 5.9% in 1975. And we project only a moderate increase in the ratio of long-term debt to GDP. The ratio of these countries' long-term debt service to their exports is actually projected to decline in 1980. This reflects our belief that there will be little refinancing of long-term debt in 1980, as Eurocurrency rates are not expected to decline much. (Table I, lines 9,10 and 11).

It is interesting to observe that the ratio of long-term debt service to exports will not be a great deal higher in 1980 than it was back in 1972 and '73, before all the trouble began.

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This may seem surprising. The reason is that these countries' exports, and thus their capacity to service foreign debt, have expanded enormously in the interim. Their exports have grown faster than their GDP, so that their ability to transfer resources abroad in order to service debt is correspondingly enlarged. In this crucial respect, economic development has improved the 11 countries' international credit standing, despite the fact that during 1973-78 net external debt rose on average about 40-45% each year — a good deal faster than their aggregate GDP (15-20% annually).

As matters stand today, then, the debt situation of the main LDC borrowers appears to be manageable. Some of them have or will have to cut back public spending, to tighten domestic credit and to devalue their currencies in order to respond to the second oil-price shock and the economic slowdown. We have assumed such policy adjustments in projecting their current account deficits and borrowing requirements for 1980-81. These adjustments also imply some slowdown in their growth in 1980 and '81. Their citizens, on average, will be less well off because of the recent rise in oil prices.

Looking further ahead, the critical questions remain oil prices and economic growth in the leading industrial countries. As we have seen, higher oil prices and growth slowdowns or recessions in industrial countries tend to raise LDC debt relative

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to the resources available to service it. This occurs because such external shocks lead to temporary surges in borrowing to cushion the impact on consumption. Much depends on whether the price of oil rises suddenly or gradually, and whether future slowdowns in the industrial world are severe or mild. If the real price of oil rises modestly and gradually, if such increases are anticipated and if future growth slowdowns are moderate, as the present one appears to be, borrowing to cushion such shocks will be less. In these circumstances, LDC debt would rise only moderately or even not at all relative to the borrowing countries' capacity to service it, as measured by their debt:GDP and debt service:exports ratios.

On economic grounds, there is reason to hope that future advances in the real price of oil will be moderate and gradual. Relative to world GNP, energy consumption is declining markedly. Also, world GNP will probably continue to grow a great deal more slowly than in the 1960s, mainly owing to "stagflation" in the United States and Western Europe. If, then, the world is spared another political breakdown in a major oil-exporting country and another war in the Middle East, large oil-price shocks may be avoided. Likewise, future recessions as severe as the 1974-75 episode seem relatively unlikely. Stagflation seems to mean slow growth but also relatively steady growth.

In sum, there are reasonable grounds for expecting the debt burden of the developing countries that do most of the borrowing to remain manageable. However, private lenders are

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unlikely to forget the Middle East War and the Iranian Revolution. They may be expected to build that memory into their portfolio policies and the interest rates they charge.

The IMF, for its part, should also be prepared with ample resources for the eventuality that things might turn out worse than expected. That, after all, is the purpose of a lender of last resort.

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TABLE I

Eleven** Major Non-OPEC Developing Countries

Selected Economic Indicators
($ Billion at Current Prices)

		1972	1973	1974	1975	1976	1977	1978	1979P	1980F	1981F
(1)	Gross Domestic Product	191.0	244.0	326.6	350.9	406.6	446.8	537.7*	666.4	765.0	890.0
(2)	Gross National Income	192.7	247.5	340.2	367.9	418.6	453.9	548.9*	686.7	790.0	910.0
(3)	Exports of Goods and Services	23.8	35.2	47.3	46.8	58.9	73.1	88.7*	107.4	129.2	152.4
(4)	Oil Import Bill, Net	0.9	2.4	6.0	6.2	7.5	7.5	7.0*	11.2	13.8	12.6
(5)	Current Account	-3.2	-2.9	-15.7	-20.5	-14.3	-9.7	-11.9*	-20.8	-24.8	-22.3
(6)	Long-term External Public Debt	21.9	27.3	36.1	47.6	61.9	78.6	104.6*	125.9	145.3	163.9
(7)	International Reserves	10.2	15.2	15.0	12.8	18.8	23.5	31.4*	35.5	33.5	34.7
(8)	Net Debt (6-7)	11.7	12.1	21.1	34.8	43.1	55.1	73.2*	90.4	111.8	129.2
(9)	Amortization of Line 6 Debt	2.5	3.6	3.5	3.7	4.7	7.8	12.1*	15.0	12.0	16.0
(10)	Interest Payments on Line 6 Debt	1.1	1.5	1.9	2.7	3.2	4.6	6.1*	7.5	8.8	10.0
(11)	Total Service of Line 6 Debt	3.6	5.1	5.4	6.4	7.9	12.3	18.2*	22.5	20.8	26.0

* - Last actual
P - Preliminary
F - Forecast

** - These eleven countries had outstanding debt of $89.2 billion due to private foreign banks as of December 31, 1978. Of the eleven, Brazil (debt: $31.9 billion) and Mexico (debt: $23.4 billion) account for over 60% of this total. Mexico is a significant net oil exporter of increasing importance. Three other net oil exporters -- Argentina (debt: $6.9 billion), Peru (debt: $3.4 billion) and Egypt (debt: $1.6 billion) -- account for nearly 15% of this debt. The remaining six countries -- Korea (debt: $7.0 billion), the Philippines (debt: $4.0 billion), Taiwan (debt: $4.0 billion), Thailand (debt: $2.7 billion), Morocco (debt: $2.2 billion), Colombia (debt: $2.1 billion) -- are all net oil importers that account for 25% of these outstanding obligations. The outstanding debt owed to private foreign banks by these eleven countries is almost 75% of the $123.4 billion owed by all developing countries to private foreign banks. The estimate of $123.4 billion includes all obligations due to privately-owned foreign banks and is not confined to debt that is long-term or publicly guaranteed.

Note: Gross National Income equals Gross Domestic Product plus imports minus exports. This is a measure of the resources currently available to a nation's citizens and is sometimes called "absorption."

Sources: World Bank; International Monetary Fund;
National Government Publications; Citibank estimates.

Citibank Economics Department
February 7, 1980

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TABLE II

Eleven Major Non-OPEC Developing Countries

SELECTED ECONOMIC INDICATORS

	1972	1973	1974	1975	1976	1977	1978	1979P	1980F	1981F
Ratio x 100										
Current Account : GDP (4÷1)	1.7%	1.2%	4.8%	5.9%	3.5%	2.2%	2.2%*	3.1%	3.2%	2.5%
Net Debt : GDP (6÷1)	6.1	5.0	6.5	9.9	10.6	12.3	13.6*	13.6	14.6	14.5
Interest : Debt (10÷6)**	5.4	6.1	6.0	6.5	5.8	6.5	6.7*	6.5	6.5	6.5
Debt Service : Exports (11÷3)	15.0	14.5	11.5	13.7	13.4	16.9	20.5*	20.9	16.1	17.1
Real GDP Growth Rates (% Annual Rate)										
Eleven Developing Countries***	6.5	8.7	5.9	4.9	7.3	5.6*	6.0	6.3	5.0	5.5
United States	5.7	5.5	-1.4	-1.3	5.9	5.3	4.4	2.0*	-0.8	2.3
Six Other Major Industrial Countries	5.6	7.2	1.1	0.5	5.3	3.2	3.9*	3.8	2.7	3.7
Average OPEC Oil Price (FOB, $/BBL)****	$2.40	$3.15	$10.15	$10.90	$11.75	$12.60	$12.90	$19.00*	$28.50	$31.00

* - Last Actual
** - Averages of year-end debt
*** - Arithmetic Mean
**** - Average price of OPEC crude oils that are commonly purchased by developing countries.
Note: Numbers in parenthesis refer to data lines on previous table.

P - Preliminary
F - Forecast

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TABLE III

FINANCING THE ELEVEN LDCs' CURRENT ACCOUNT DEFICITS

($ Billions)

	1973	1974	1975	1976	1977	1978	1979	1980	1981
Current Account Deficit	-2.9	-15.7	-20.5	-14.3	-9.7	-11.9	-20.8	-24.8	-22.3
Financed by:									
(1) Change in Reserves (+=decrease)	-5.0	0.2	2.2	-6.0	-4.7	-7.9	-4.1	2.0	-1.2
(2) Direct Investment	2.2	2.4	2.4	2.6	3.0	3.5	4.0	4.5	5.0
(3) Increase in Long-term External Public Debt	5.4	8.8	11.5	14.3	16.7	26.0	21.3	19.4	18.6
(4) Residual Capital Flows (+=inflow)	-5.5	4.3	4.4	3.4	-5.3	-9.7	-0.4	-1.1	-0.1

Sources: World Bank; International Monetary Fund;
National Government Publications; Citibank estimates.

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February 7, 1980

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Chairman NEAL. Thank you. Professor Dunn.

STATEMENT OF PROF. ROBERT M. DUNN, JR., GEORGE WASHINGTON UNIVERSITY

Professor DUNN. Thank you. I am honored to be here, and thank you for your time. I will try to keep my comments brief. I have prepared a statement for the record, which I would like to briefly summarize before touching on some of the other questions in the letter of invitation.

I should start by noting that I support the U.S. contribution to the increased quotas of the Fund, but I would not support the amendments designed to limit or change the conditionality process. I suppose that I am a little less optimistic than my colleague to the right. Bankers are supposed to be dour, but he was not dour at all in his view of the petrodollar recycling process.

The problem of OPEC surpluses and petrodollars recycling is back with us, and with a vengeance; 1975 through 1978 was a temporary period of claim. OPEC current accounts surpluses declined from a very high level in 1974 to the $30 to $40 billion range in 1975–77, and almost approached zero in 1978. There were two reasons for this pattern.

The first was, the very rapid growth of OPEC imports, and the second was the fact that the terms of trade of the OPEC countries were very stable in 1975 through 1977, before decline by 10½ percent in 1978 due to stable oil prices and rapid inflation in the rest of the world.

The decline in the OPEC current accounts surplus was paralleled by a fairly healthy situation for non-oil-developing countries. Their deficits did not grow rapidly. They were basically stable between 1974 and 1978 at about $30 billion, falling a bit, then rising.

If those figures are put in real terms by deflating them for inflation, the current accounts deficits of the nonoil LDC's clearly declined. This ended in 1979 when OPEC prices went up very sharply. A new factor that will affect the OPEC surpluses is the current wave of religious fundamentalism in the Middle East, which will discourage modernization and fast economic development. This will reduce the rate at which many of these countries import capital equipment and construction services.

This will further increase the current accounts surpluses of the OPEC countries. The deficits of the nonoil LDC's rose by about 50 percent in 1979, to a little over $45 billion, and the predictions I have seen suggest about $60 billion in 1980. The OPEC surpluses were up from $7 billion in 1978 to about $60 billion in the year that just ended. Nobody knows what it will be this year, but most estimates are for $90 billion to $100 billion. I doubt that there will be any great decline in the succeeding years, particularly if this Islamic fundamentalism really does slow down major investment or modernization projects in the Middle East.

The relative calm of 1975–78 in the international financial system is coming to an end, and consequently the International Monetary Fund and other international financial institutions can expect renewed pressures for funds. The lack of heavy activity in lending by the IMF during the last couple of years is not a good indicator of what we will see in the next 3 or 4.

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Once the foreign exchange reserves of many developing countries starts to decline, they will probably be coming to the IMF again and the quota increases will be needed, despite the fact that lending activity in the last couple of years has not been heavy.

One might ask why the balance of payments adjustments process has not worked for OPEC surpluses. Normally we think that a balance of payments surplus will generate forces inside an economy which will lead that surplus to be adjusted or done away with. I think this has not happened in the OPEC case because of some arrangements which largely isolate the internal OPEC economies from their external or oil sectors.

First, the OPEC countries accept payment and set prices in dollars and hold surplus funds in dollars, so there is no exchange rate pressure on the OPEC currencies. When they have surpluses, their currencies do not appreciate. Second, the oil is owned, produced, and sold by governments, rather than by individuals or private firms within the OPEC economies. As a result when oil revenues rise, there is no automatic increase in private or corporate incomes inside the economy. Private incomes within the economy are largely isolated from the oil sector unless the government chooses to pass some of the funds through.

For the same reason the money supplies of these countries are not affected by the surpluses. Normally we think that unless sterilization occurs, a balance of payments surplus increases the money supply of the surplus country. But if the government takes in all the revenue, it is not required to pass it through as incomes to the private sector. There is no reason for the privately held money supply to rise.

So within the OPEC countries the exchange rate, domestic private incomes, and the privately held money supplies are largely isolated from the external or oil sector. This cuts off the three major forces for adjustment that a surplus is expected to generate. Since the OPEC governments get this money and hold the cash balances, one might expect them to act like an individual, that is, as cash balances and incomes rise, to spend it and to spend it in sufficient volume to produce current account adjustment.

This has happened in those OPEC countries that have large populations relative to oil revenues and which have ambitious development or military goals. It has not happened and cannot be expected to happen in the short list of countries which have massive oil revenues, tiny populations and no reasonable way to spend the money; Saudi Arabia, Kuwait, the United Arab Emirates, Iraq, and perhaps one or two others do not have any mechanism for adjusting their balance of payments and will remain in massive current accounts surplus for quite a while.

Current pressures for a return to Islamic fundamentalism in the Middle East will have the effect of increasing these surpluses by reducing imports of goods and services. The question then becomes how the current accounts deficits of the rest of the world are to be financed. If OPEC runs a surplus of $90 billion then the rest of the world must have a deficit of the same size. I do not foresee any sizable or major problems for the strong OECP countries because the surplus OPEC countries take payment for their surpluses by accumulating financial claims on the rest of the world, the OPEC

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countries must lend to the rest of the world—except to the limited extent that they buy gold—if they have surpluses. They have shown a very strong preference for accumulating claims on—lending to—the strong industrialized countries, the United States and its friends in Europe and Japan really do not have to adjust their current account deficits and, it would be very destructive if we tried to do so except by cutting oil demand.

If we take any other route to try to adjust our current account deficits, while OPEC maintains a surplus of $60 or $90 billion, we merely shift the deficits to developing countries and others who have no prospect of finding sufficient financing.

The real problem is the non-oil-developing countries and this is where the International Monetary Fund and the increase in quotas becomes important. The OPEC countries have shown a decided lack of interest in lending large amounts of money directly to the nonoil developing countries. The financing gap has been filled for the last 5 or 6 years largely by major private banks who have carried out a process sometimes known as indirect recycling. Funds come into these banks as Eurodollar deposits or in other forms from the OPEC countries and then are relent to the developing countries.

The growth of private bank claims on the nonoil developing countries has been very striking. According to Bank for International Settlements figures, which were quoted in a Morgan Guaranty letter, these debts went from $33½ billion in 1974 to about $150 billion at the end of 1979. Even allowing for inflation that is a very large increase. I doubt very much that the private banks in the major financial centers can prudently continue to lend additional funds to the nonoil developing countries at this rate.

If the banks cannot carry on this process as they have in the last 5 or 6 years, and if the OPEC countries remain uninterested in lending large sums directly to the nonoil developing countries, where are the funds to come from?

Increased pressure on the World Bank, the IMF, the Inter-American Development Bank, and the Asian Development Bank for Funds can be expected. As foreign exchange reserves of the developing countries fall, more and more of these countries will show up at 19th and G Streets. The problem is that the International Monetary Fund is not an aid-granting institution. It is not intended as a source of long-term funds. At the Bretton Woods Conference late in the Second World War, a clear distinction was made between two goals: Long-term reconstruction and development financing which was to be handled by the World Bank—which has a soft loan window, the IDA—and short-term balance of payments financing in somewhat larger sums which was to be handled separately through the IMF. This distinction has been maintained, and I think it ought to continue to be maintained.

The fact that the IMF is not an aid-granting institution, does not make soft loans, and is not in the long-term lending business necessitates conditionality. Conditionality may sometimes seem unfortunate, but it is an absolute necessity if the IMF is to have any prospect of being repaid and if many developing countries are to avoid simply running out of money to pay for basic imports.

I would note the article in the Washington Post yesterday with regard to the circumstances in Turkey and suggest that if the

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Turkish economy had been put through a conditionality exercise a few years ago it would not now be in its chaotic state. If the developing countries do not have sources of long-term funds, they really have no choice but to bring their current accounts to equilibrium. That means conditionality.

It should be noted that the balance-of-payments problems of many developing countries which require IMF help and conditionality are often caused by extremely unwise economic policies. The IMF is brought in to clean up the mess and gets blamed for having caused it. A pattern is often repeated: A government comes to power, by election or otherwise, promising huge increases in government expenditures on good things, with no prospect for tax receipts to pay for them; expenditures go up; tax receipts do not. The government deficit becomes very large, and since the government has no major domestic borrowing source, it has no choice but to monetize the deficit, that is, they finance with the printing press. The result is rapid inflation, the balance of payments goes into huge deficit, foreign exchange reserves decline and approach zero, and the IMF arrives. The IMF has to impose a rather tough stabilization program to put the government policies back on an even footing in order to get control of the rate of growth of the money supply, and ends up being blamed for the results.

The resulting problems are not the IMF's fault. The fault lies with the earlier policies that got the country in the huge deficit. To blame the IMF is to blame the messenger for the message.

All the IMF did was bring the unhappy news. To encourage or force the IMF to end or weaken the conditionality process is to ask it to lend with no prospect for repayment, and to create circumstances in which, many of these countries will eventually run out of foreign exchange and end up insolvent.

Before judging the harshness of an IMF conditionality policy, one must look at the preceding policies in the developing countries which led to the balance-of-payments problems which required IMF help.

Fundamental solutions to the LDC financial problems require, at least things. First, the OPEC countries have got to be encouraged to do much more direct lending to developing countries. I do not think that the indirect process through the commercial banks can go on as it has. In deference to my colleagues from the commercial banks, I think the recycling process requires less commercial banking and more investment banking. Instead of commercial banks borrowing and relending, firms like Kuhn, Loeb, Goldman, Sachs, and others package loans which are passed directly through to the OPEC countries.

Somehow the OPEC countries have got to be led to the conclusion that it is in their interests for the developing countries to be able to finance their deficits for a few years and that the old system won't work.

Finally, the adjustment of the underlying balance-of-payments disequilibrium requires that the demand for OPEC oil decline- to a point at which OPEC revenues roughly match their import absorptive capacities. Since the United States is the largest oil consumer, I think that process of declining oil demand probably has to start here.

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For the time being, however, the IMF is going to be a far more important lender than it has been in the last few years. It needs the quota increases, and I think we should contribute. I do not think we ought to put restraints on the conditionality process.

In response to another question in the letter, I do not think there is any way to be sure whether or not IMF funds are used to repay bank loans. Any money which a developing country takes in from export proceeds, IMF drawings, or whatever, can be used for that purpose. I do not think that this question is really terribly important. These are largely U.S. banks and I do not think it would be such an awful thing if some of this money were used that way. The most important role that the IMF can play for the banks is to encourage policies which indicate to the banks that they have some prospect for being repaid.

[Professor Dunn's prepared statement entitled "OPEC Surpluses, the International Payments Problems of Developing Countries and the IMF" follows:]

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Prepared for:

Hearings

Subcommittee on International Trade,
Investment and Monetary Policy
Committee on Banking, Finance, and
Urban Affairs
U.S. House of Representatives
Ninety-Sixth Congress

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OPEC SURPLUSES, THE INTERNATIONAL PAYMENTS PROBLEMS OF DEVELOPING COUNTRIES, AND THE IMF

Robert M. Dunn, Jr.

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The recent increases in the price of OPEC oil have greatly worsened the current account deficits of the oil importing countries. The necessity of financing these deficits means that the international financial system will be operating under strains as serious or worse than those of 1974-1975 in the next few years, and that the financial role of the International Monetary Fund (IMF) is almost certain to become far more important than it has been in recent years. The massive OPEC surplus (with the parallel deficit in the rest of the world) of 1974 was followed by far more modest surpluses in 1975-1977 and by approximate equilibrium in 1978. The 1975-1978 decline in the OPEC current account surpluses was the result of a combination of a sharp increase in the volume of OPEC imports and stable or declining OPEC terms of trade. Inflation in the rest of the world and relatively stable oil prices produced virtually constant OPEC terms of trade in 1975 through 1977 and a 10.5 percent decline in 1978.* This sharp worsening of oil exporters' terms of trade was a dominant cause of the 1978 reduction in OPEC current account surplus to only $7 billion. Some overly optimistic analysts suggested at that time that the international financial problems resulting from increased oil prices had been solved and that normality had returned.

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* IMF Survey, September 17, 1979, p. 287.

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1979 brought any such happy thought to a sudden end. The combination of sharp increases in oil prices and strong demand at almost any price has produced an OPEC current account surplus of about $60 billion for 1979, and most forecasters now expect the 1980 surplus to be almost $100 billion, with no likelihood of sharp declines in immediately succeeding years. It is very unlikely that the OPEC countries will allow a terms of trade deterioration such as occurred in 1978, and the rapid rise of Islamic fundamentalism in the Arab oil producing countries is almost certain to cause a slowing down of major development and modernization programs which are based on imported goods and services. Unless the OPEC countries decide to reduce oil production sharply, they are virtually certain to have huge surpluses during the next few years.

The normal forces for the adjustment of balance of payments disequilibria do not operate in the case of the oil surplus countries because of an unusual arrangement which virtually isolates the internal economies of the OPEC countries from their oil or external sectors. Since the OPEC countries set prices and accept payment in dollars, a payments surplus generates no upward pressure on the exchange rates for OPEC currencies, or downward pressure on the exchange rates of the oil importing countries as a group. Since the OPEC governments, rather than private individuals or enterprises, own and export the oil, a growing surplus does not automatically increase personal incomes or corporate profits within the OPEC economies which would encourage rising private expenditures and growing imports. Since governments rather than the private sector receive payments for oil, OPEC surpluses have no automatic impact on the domestic money supplies of the oil exporting countries. The OPEC governments receive payments for oil in foreign exchange and do not have to pass funds through to domestic residents as increases in incomes or money supplies. This arrangement largely eliminates the major automatic forces for adjustment of a large payments surplus.[1]

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1. These arguments are dealt with in considerably more detail and are extended in Robert M. Dunn, Jr., "Exchange Rates, Payments Adjustment, and OPEC: Why Oil Deficits Persist," Princeton Essays in International Finance, forthcoming.

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Since the OPEC governments receive the increases in income when oil prices rise, they might be expected to behave like an individual whose income and cash balances have increased; that is, they might be expected to increase foreign and domestic expenditures sufficiently to produce payments adjustment. This has occurred in those OPEC countries whose populations and development (or military) goals are large relative to their oil revenues. It has not happened, and can not be expected to occur, in a few countries which receive huge oil revenues but which have tiny populations and no rational way to spend all of their receipts on domestic projects. Saudi Arabia, Kuwait, the United Arab Emirates, and Iraq cannot possibly spend their current incomes on intellegent development programs, and current religious pressures on those governments are likely to reduce their recent modernization efforts and hence cut imports. There are no automatic forces for payments adjustment in these countries, and as a result OPEC is almost certain to retain a huge current account surplus for the next few years. If OPEC has a current account surplus of almost $100 billion, the rest of the world must have a deficit of the same size, which raises the question of how such deficits are to be financed.

The industrialized countries of the OECD are likely to have few if any major financing problems. The OPEC countries must accumulate financial claims on the rest of the world in payment for their current account surpluses, and these countries have shown an inclination to invest in the stronger economies of western Europe, North America, and Japan. If the OPEC countries run current account surpluses, they must lend to the rest of the world one way or another, and they have typically lent to the United States and its allies.[2] These countries are not compelled to bring their current accounts to equilibrium because OPEC financing is available, and any attempt by the OECD countries as a group to adjust their current accounts would be counterproductive under present circumstances. The oil importing world must run a current account deficit which is the offset of the OPEC current account surplus, and any attempt by the OECD countries to move to current account equilibrium would simply shift all of the deficit to developing countries which have little or no chance of arranging sufficient financing.

2. OPEC purchases of gold are a modest alternative to accumulating financial claims on the rest of the world Under present circumstances gold might be viewed as merely a commodity and hence as a current account import by the OPEC countries. Whether gold is viewed as an ordinary commodity or as a foreign exchange reserve asset, the volume of gold purchased by OPEC is likely to be very small relative to their oil export revenues. Current account surpluses still mean accumulating financial claims on the rest of the world.

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The non-oil developing countries do not have the automatic option of running large and continuing current account deficits because they do not have ready access to financing. The surplus OPEC countries have shown a clear lack of interest in lending large sums to the non-oil developing countries, so these countries can run current account deficits only to the extent that they can find financing elsewhere. Private commercial banks in New York, London, and other financial centers have provided a sizable part of this financing during the 1974-1979 period through a process that is sometimes known as indirect recycling. Funds flow from the surplus OPEC countries to banks in a variety of forms including Eurodollar deposits and are then relent to deficit developing countries. The banks understandably try to avoid making large loans to high risk countries, so the vast majority of these funds have gone to strong developing countries such as Brazil, South Korea, and Tiawan. Some loans have gone to more doubtful borrowers such as Zaire, Jamaica, and Peru, but the banks which made these loans may now wish that they had avoided them.

The poorest developing countries are typically unable to borrow large sums in the private market, and are dependent on foreign aid and on loans from institutions such as the World Bank and the IMF to finance oil deficits. Since oil consumption is directly related to the level of economic development, the poorest countries use much less oil per capita than do countries such as Brazil and South Korea, so their borrowing needs are not increased as sharply when oil prices rise. They are seriously affected by OPEC prices, however, and do not have access to the private financing arrangements which have been used by the stronger developing countries. Relatively strong terms of trade and good crop years protected many of the poorer developing countries from some of the impact of rising oil costs during 1977 and 1978, but 1979 was more difficult and 1980-1981 will be far worse.

The current account deficit of the non-oil developing countries actually declined from $29 billion in 1974 to $23 billion in 1977 before rising to $30 billion in 1978. If these figures were deflated for world inflation, a downward trend in the real deficit would be clear. In 1979, however, the deficit appears to have grown to $45 billion, and current forecasts suggest $60 billion for 1980.[3] A serious recession in the United States and other industrialized countries would increase this figure by reducing the demand for industrial raw materials which the developing countries export.

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3. Morgan Guaranty Trust Company of New York, World Financial Markets, 12/79, p. 3.

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It is far from clear at present how financing can be arranged for developing country deficits of this size, and the IMF is almost certain to become far more important as this financing problem develops. There is a fairly widespread feeling in financial circles that the major private banks in the United States and abroad are close to fully extended in many developing countries. Unless some form of loan guarantees can be arranged, it is hard to see how these banks can continue to lend to the non-oil developing countries in the volumes of recent years. According to the Bank for International Settlements data, private bank claims on non-oil developing countries grew from only $33.5 billion in $121.7 billion between 1974 and the end of 1978, and the best estimate for the end of 1979 is $150 billion.[4] Even allowing for inflation, this is a massive increase in bank lending to the non-oil developing countries, and it seems very unlikely that the banks can prudently continue to make such loans at this volume.

If private banks are unlikely to recycle a large volume of funds to the developing countries, the official international financial institutions are certain to become more important, and the IMF in particular will be under increased pressure to provide more funds to these countries. It is interesting that although total drawings on the IMF declined during 1979, drawings by non-oil developing countries increased substantially and constituted 75 percent of the total by the end of the year.[5]

The prospect for far greater demands on the IMF by the non-oil developing countries might appear to suggest that conditionality requirements be eased. Since the oil importing countries as a group must run a payments deficit of almost $100 billion during 1980, why should developing countries be compelled to adopt painful policies to move toward current account equilibrium? The dominant reason is that many developing countries have no permanent sources of borrowed funds and consequently must move toward current account equilibrium if IMF drawings are to be repaid and if insolvency is to be avoided. The industrialized countries as a group do not have to move to current account equilibrium because the surplus OPEC countries are willing to finance their deficits by accumulating financial claims on them. The developing countries

4. Ibid., p. 3.
5. IMF Survey, February 4, 1980, p. 33.

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are in a less favorable position. Since the surplus OPEC countries have not shown any interest in lending large sums to them directly and the private banks are unlikely to continue the indirect recycling process at the volume of recent years, these countries can run large current account deficits only to the extent that they can find new sources of financing. Since the IMF is not intended to provide aid grants or long-term loans, it must insist that the non-oil developing countries adopt policies which will produce current account positions which can be financed. Conditionality is necessary if the IMF is to have any prospects of being repaid or if the developing countries are to avoid simply running our of money to pay for vital imports. Conditionality requirements may seem harsh, but for countries that cannot secure large scale and long-term financing from OPEC or elsewhere, there is no alternative to the current account adjustment which conditionality requirements are designed to produce.

The policies called for under the conditionality requirements of the IMF have undoubtedly caused political and social problems in some developing countries, but it ought to be noted that the original payments deficits which required IMF assistance have often been caused by profligate and irresponsible economic policies. Governments have often come to power in developing countries by promising vast increases in public expenditures without any prospect of matching tax receipts. Policies are often undertaken which discourage economic activity, and tax revenues actually fall. Huge public sector deficits result and, since no domestic sources of borrowed funds are available, the deficit is financed by printing money. Rapidly accellerating inflation follows which produces a massive balance of payments deficit. Foreign exchange reserves decline rapidly and approach zero. An IMF drawing is requested and policies are required under conditionality which hold some promise for returning the public sector to financial stability, sharply reducing the rate of growth of the money supply, and producing successful balance of payments adjustment. To blame the IMF for the resulting social and political problems is to blame the messenger for the message. The fault lies with the original policies which caused the massive public sector deficits and the resulting inflation, and the role of the IMF is merely to deliver the unhappy news. To ask the IMF to allow large drawings in such situations without imposing conditionality is to ask it to lend with no prospect for repayment.

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Until the non-oil developing countries can find major sources of continuing capital inflows, they will have to manage their policies in a way which is designed to limit their current account deficits to what they can now reasonably expect to borrow. That may not be pleasant, but it is unavoidable.

The solutions to the problem of OPEC surpluses and developing country deficits lie in two areas. First, the surplus OPEC countries must somehow be convinced that it is in their interest to do much more direct lending to non-oil developing countries. The indirect recycling process which has operated primarily through large commercial banks cannot be expected to continue in the pattern and volume of the last six years. Since other sources of medium or long-term funds are not readily available, OPEC must lend directly to the developing countries if they are to avoid serious financial problems. Until that occurs, the IMF has no choice but to impose conditionality requirements on the developing countries which will produce current account deficits which are no larger than those they can expect to finance from currently available sources.

Second, the OECD countries must sharply reduce their demand for OPEC oil. The world's payments system cannot return to anything approaching equilibrium until the demand for OPEC oil approximately matches the ability of the OPEC countries to absorb imports. Since the United States is the largest oil importer, such reductions in the demand for OPEC oil should start here.

Chairman NEAL. Thank you very much.
Ms. Junz?

STATEMENT OF HELEN B. JUNZ, VICE PRESIDENT, FIRST NATIONAL BANK OF CHICAGO

Ms. JUNZ. Mr. Chairman, I am privileged to appear before you in support of the enactment of H.R. 5970, a bill to increase the quota of the United States in the International Monetary Fund (IMF) by an amount equivalent to SDR 4,202.5 million. Like my colleague Professor Dunn, I do not support the amendments that would restrict conditionality.

Also like Professor Dunn, but unlike Mr. Cleveland, I count myself among those current day optimists who say today is good because tomorrow will be worse. I do believe that the time of general repayment of debt to the IMF is coming to an end and that the early 1980's will be characterized by payments imbalances even greater than those we saw in the 1970's.

As Professor Dunn pointed out, the OPEC current account is once again in surplus and is so with a vengeance. Despite the currently high oil inventories, the demand-supply situation for oil remains precarious. Oil prices this year are likely to average at least $30 a barrel. Under these circumstances, OPEC's current account surplus should rise to $120 billion or more in 1980.

I also do not believe that we will see an erosion in the real value of oil, as we saw after the 1973-74 episode. The OPEC countries—and let me say, not just OPEC; also our friends along the North

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Sea—have learned that they are very powerful economic agents. And like any powerful economic group, they are trying to assure that their share of world income does not erode.

In addition, the cutbacks in import demand by Iran, the adoption of increasingly prudent economic programs by a number of other oil-producing countries, and the rising earnings flows from investments, as interest rates move to historically high levels and accumulated assets grow, all contribute to the large jump in unspendable OPEC revenues. Furthermore these factores also suggest that OPEC surpluses are likely to remain high for an extended period of time.

In 1980 the counterpart of these surpluses will be reflected in a $70 billion current account deficit for the industrialized countries and at least a $50 billion deficit for the nonoil developing countries. The extent to which such deficits will prove financeable is uncertain.

A large part of the financing needs will fall on the smaller industrialized countries, and on those non-OPEC LDC's, who are already in relatively weak external positions and whose debt positions are already high.

Accordingly, adjustment of growth objectives, or at least of the composition away from consumer goods, will be required progressively. But even countries in a position to finance deficits for some period of time will need to adjust their economies to the current realities.

In this respect the early 1980's are quite different from the early 1970's. Then, many policymakers believed that the large change in oil prices represented a one-time shock to the system and, in any event, might prove not to be sustainable. Thus it was thought appropriate that external deficits should be financed in order to sustain growth, and that adjustment measures could be spread out over a considerable period of time. But experience has proven that the change in the relative price of oil is here to stay and that postponement of adjustment only compounds the problem. As it becomes increasingly important that such financing should speed rather than postpone adjustment, the IMF will be called upon to play a dual role.

First, official financing, including drawings on the IMF, as a percent of total financing, will need to rise over the next several years. Second, the Fund, as you know, has been given the responsibility to help to assure that all member countries, be they in external deficit or surplus, pursue policies to achieve basic economic stability. Because this in turn, provides the basis for orderly expansion of the international trading and financial network, the Fund's activities in this area are extremely important and should be strengthened. The bulk of the financing requirements will be met by the private sector in one way or another. But recent events have increased the perception of risk among lenders, and thus for a growing number of borrowers costs are likely to be higher and loan maturities shorter than they have become accustomed to. And this will occur at a time when borrowing needs will vastly increase. For the non-oil-developing countries as a group, debt levels have at least tripled since 1973. As Mr. Cleveland pointed out, because prices for LDC exports also rose fast, debt service as a percent of

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exports has risen much more slowly. Nevertheless, it has risen to about 18 percent in 1979.

Owing to higher oil prices, with rising interest rates, and further large additions to debt, energy requirements combined with debt service are likely to absorb about one-half of export revenues in the early 1980's. Averages of this sort, of course, mask widely different situations, ranging from those where servicing of existing debt has already proved most difficult, such as Turkey, Zaire, Zambia, and the Sudan, to those where the current debt and reserve positions allow further assumptions of debt, such as Mexico, Taiwan, and a number of other countries mentioned by Mr. Cleveland.

For most countries, access to financing has been relatively easy over the past several years. And as you know, in 1979, repayments outnumbered borrowings from the Fund. But I would say that some of the ease of financing over the last several years is really associated with excessive monetary ease in a number of industrialized countries in general and in the United States in particular.

Now, however, faced with rising inflationary pressure at home and potential turbulence in the exchange markets abroad, monetary authorities almost everywhere aim to hold down credit expansion. If governments are successful in controlling monetary expansion, the overabundance of liquidity in world financial markets should disappear, and this in turn should induce greater use of the IMF's conditional financing facilities.

Given the size of the prospective financing needs and the recent liberalization of access to various Fund facilities, increased recourse to the Fund could well strain its resources before long. Failure to provide adequate resources now could lead to a patchwork of temporary, hastily constructed facilities that are not likely to meet requirements as efficiently as would the permanent facilities of the Fund.

In addition, I think in these times of uncertainty and strain on international cooperative efforts, it is even more important than ever that the Fund's resources not be under threat of being preempted by possible drawings by one or two large industrial nations.

Even with the large amounts available through the IMF, Fund financing can only be a complement to private sector financing, and a relatively small one at that. But its contribution could be crucial. The lesson to be drawn from the recent financing and adjustment difficulties of a number of countries is that belated stabilization efforts are costly, both in economic and political terms.

The fact that in a number of cases bank financing has perhaps been available too easily and that countries have gone to the Fund only after a crisis situation has become apparent and other sources of financing have dried up has been much debated. Of course, banks need to evaluate lending risks properly. But it is not reasonable to look to them to impose policy conditions on recipient governments.

Governments are sovereign entities and such interference would be wholly inappropriate. In addition, it would require joint exercise of pressure by the banking industry, which surely would not be desirable.

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Nor is it reasonable to assume that the Fund can force a member government to subject itself to conditional financing. This implies the exercise of supranational powers the Fund does not possess. But more important, stabilization policies cannot be successful unless governments are convinced of their necessity and back them fully.

An unfortunate fact is that most governments faced with politically and socially difficult problems prefer to put action off as long as possible. Under these circumstances, problems tend to become increasingly intractable and solutions more and more difficult to effect. Unfortunately, economic mismanagement is not like the common cold, which can be cured more easily once it has developed into pneumonia. Nor can those who prescribe the cure be held responsible for the illness or for the bitterness of the medicine.

The stabilization programs worked out by the Fund in conjunction with member governments are a crucial part of any correction of payments difficulties that are not of a temporary nature. The economic framework within which these programs are developed presupposes that economies will respond to price and profit stimuli. This means they work through the price mechanism, including the exchange rate, and through the control of credit expansion, in particular credit to the public sector.

This approach has been variously criticized. But recent economic research tends to support these orientations. It is true, of course, that economic adjustment often hits those hardest who can afford it least. But it is equally true that the consequences of inflation and misallocation of resources will tend to affect the economically and socially disadvantaged even more.

Economic stabilization programs, as they attempt to return economies to a sustainable growth path, may temporarily interrupt the growth of real incomes and at times actually produce a fall in real incomes. But allowing imbalances to persist will progressively undermine productive potential and thereby permanently reduce the potential for greater well being.

This doesn't mean that corrective measures shouldn't be fashioned in such a way as to mitigate hardships, particularly for those least able to bear them. But realism also dictates that those economically most advantaged not be penalized too heavily, since they have the option to shift both their wealth and their productive capacity abroad.

The unfortunate fact is that resources are not limitless; however, expectations are. And the success of any stabilization policy depends upon the acceptance of that fact.

Mr. Chairman, in your letter you had asked me to comment also on the proposal for a substitution account in the IMF. I don't know whether, with the orientation of the current testimony and the time, you would like me to comment on that or just leave if for the record.

Chairman NEAL. We would be happy to hear it.

Ms. JUNZ. OK. I feel that the hard facts that I have just laid out are of course made even harder to correct in an environment of international monetary strain, and the potential for international monetary strain has increased significantly, not only by the emergency of the large investable OPEC surpluses, but also because

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official holders of financial assets are attempting to diversify their portfolios, particularly away from the dollar.

The official international community is focusing its search for a way to smooth this diversification process on the current proposal for a substitution account in the IMF. The major advantages cited in favor of the proposal are: one, that it would allow reserve asset diversification to proceed without disrupting the exchange markets; two, that it would result in an SDR-based system rather than in a multicurrency system; three, that it would move the SDR toward the center of the international financial system.

In reality, however, the choice no longer is between either a multicurrency reserve or an SDR system. A multicurrency reserve system is already evolving, as shown by the appreciable rise in the DM, yen, and Swiss franc components in the holdings of official reserves. This process appears to be accelerating. The bulk of official reserve assets apparently is being invested with an eye both to obtaining the highest possible returns and to match asset to liability structures.

Accordingly, SDR-denominated securities may be attractive mainly to those monetary authorities who in any event do not constitute the volatile segment among asset holders. Recent attempts by the private market to issue SDR-denominated securities have not met with any significant response, indicating that current investment objectives do not favor such securities.

Finally, the substitution account as currently envisaged would not meet the major requirements of high liquidity and relative anonymity stressed by a number of official reserve asset holders. Thus the initial size of the proposed account, some 50 billion SDR's, may be realistic in terms of probable demand, but is totally dwarfed by the size of existing official portfolios, and even more by the projected OPEC reserve accumulation.

While the substitution account proposal seems not adequate to deal with the problem of portfolio balancing that official asset holders attempt, the negotiation process could become extremely costly in political terms.

For example, the question of the sharing out of costs and exchange risks is an exceedingly difficult one to solve and could absorb a fair amount of political capital. Furthermore, general acceptance depends upon the support not only of the reserve rich but also of the reserve poor. In this respect, the developing countries, rightly or wrongly, are likely to construe the proposal as a willingness of the international community to bail out the United States, while it has been unwilling to move similarly to fund LDC debt.

Proposals to use a portion of the Fund's gold as backing for the substitution account at a time when Fund auctions, the source of finance for the LDC trust fund, are to end, also would add to this perception. At a minimum, the pressure to link new SDR allocations to aid is likely to increase.

This would inhibit the proper functioning of the adjustment process, as it would tend to postpone the adoption of needed adjustment measures while it would not enhance the role of the SDR as the main reserve asset.

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One is led to ask, at a time when international cooperation is at a premium, as many countries appear to be adopting increasingly self-centered attitudes, and when the international financial system faces serious potential strains, whether political capital and the energy of high officials should be diverted to this issue.

The difficulties of recycling funds from surplus to dificit countries and, in the process, of assuring smooth and adequate adjustment, clearly deserve the highest priority. The banking system will play a dominate role in the recycling process, but this may have to take less traditional forms. Banks, particularly in the United States, have to look increasingly to maintain appropriate capital/asset ratios, and together with the supervisory authorities, have a heightened awareness of the risks associated in concentrating lending in particular countries or sectors.

Thus, there may be limits to the traditional way of intermediating surplus savings, as Professor Dunn has already pointed out. The industry has proven to be innovative and will find ways and means, possibly through brokerage-type activities, of bring borrowers and lenders together. But to assure that lending to any particular customer does not become excessive, information flows regarding the balance sheets of borrowers need to be improved. The work currently proceeding in the BIS, the World Bank, and also the information provided to U.S. supervisory authorities, is helpful in this respect. But more needs to be done.

If countries wishing to borrow would make available information on their overall financial condition of the type now provided by corporate and private borrowers, would-be lenders could provide a smoother flow of financing and borrowers could exercise better control over their financial condition. On the whole, this would provide a better basis for earlier, and therefore easier and more effective adjustment.

Even with this information flow, of course, Chrysler-type situations cannot be avoided, but their number at least can be limited.

In addition, IMF lending, particularly through the longer-term facilities, could be more effective if the current process of mutual coordination with the multinational development institutions could be strengthened.

Finally, any arrangements that attempt to smooth the funnelling of financing from surplus to deficit countries cannot be successful in the absence of sustainable growth of world markets and reasonable price stability. This largely depends on the domestic policies pursued in the major countries of the world economy, but it does make the surveillance function and, therefore, the vitality of the IMF increasingly important.

Thank you.

[Ms. Junz's prepared statement follows:]

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STATEMENT BY
HELEN B. JUNZ
VICE PRESIDENT
FIRST NATIONAL BANK OF CHICAGO

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL TRADE, INVESTMENT
AND MONETARY POLICY
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES

Mr. Chairman, Members of the Subcommittee, I am privileged to appear before you in support of the enactment of HR 5970, a bill to increase the quota of the United States in the International Monetary Fund (IMF) by an amount equivalent to SDR 4,202.5 million. You have asked me to comment first, on the merits of this increase, particularly in view of the apparently ample current liquidity position of the IMF; second on the view, at the one extreme that the IMF has imposed policy conditions on borrowers that involve excessively high social costs and at the other extreme, that extension of IMF credit has encouraged excessive private lending, and thus postponed adjustment and unnecessarily increased debt burdens. Third, you have asked that in answering these questions I focus on the related issue of the large prospective OPEC current account surpluses and the phenomenon of official reserve asset diversification, in particular the proposal for a substitution account in the IMF.

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It is true that the bill before you asks you to expand the IMF's resources at a time when the Fund's liquidity is at relatively high levels and when members, on average, have been reducing their indebtedness to the Fund. But this situation, unfortunately, is likely to be short-lived. The large external payments imbalances and associated financing problems that characterized most of the 1970's will be with us to an even greater extent in the early 1980's.

The OPEC current account which was nearing balance in 1978, rose to about $60 billion[1/] in 1979. Despite the current high level of oil inventories, the demand/supply situation this year--in the absence of strong measures to curtail imports-- will remain precarious. Accordingly, oil prices will average over $30 a barrel. Under these circumstances, OPEC's current account surplus is likely to rise to $120 billion or more in 1980. The cut backs in import demand by Iran, the adoption of increasingly prudent economic programs by a number of other oil producing countries, and the rising earnings flows from investment as interests rates have moved to historically high levels and accumulated assets grow, all contribute to the large jump in unspent OPEC revenues. Furthermore, these factors also suggest that OPEC surpluses are likely to remain high for an extended period of time.

In 1980, the counterpart of these surpluses will be reflected in a $70 billion current account deficit for the industrialized countries and a $50 billion deficit for the non-oil developing countries. The extent to which such

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1/ Including official transfers.

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deficits will prove financeable over time is questionable. The larger part of financing needs will fall on the small industrialized countries, who already are in a relatively weak external position and on those non-oil developing countries whose debt positions are already high. Accordingly, progressive adjustment of growth objectives, or at least of the composition of output away from consumer goods will be required. But, even countries in a position to finance deficits for some period of time will need to adjust their economies to the current realities.

In this respect the early 1980's are quite different from the early 1970's. Then many policy makers believed that the large change in oil prices represented a one-time shock to the system, and, in any event, might prove not to be sustainable. Thus, it was thought appropriate that external deficits should be financed in order to sustain growth and that adjustment measures could be spread out over a considerable period of time. But experience has proven that the change in the relative price of oil is here to stay and that postponement of adjustment only compounds the problem.

Still, as long as the oil exporting nations do not spend their earnings on imported goods and services, corresponding deficits will exist and will have to be financed. But, it is becoming increasingly important that such financing should speed rather than postpone adjustment. In that process the IMF will need to play an increasingly important part. The IMF's role in this respect is a dual one. First, official financing, including drawings on the IMF, as a

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percent of total financing, will need to rise over the next several years. Second, the Fund has been given the responsibility to help assure that all member countries, be they in external deficit or surplus, pursue policies to achieve basic economic stability. Because this, in turn, provides the basis for orderly expansion of the international trading and financial network, the Fund's activities in this area are extremely important and should be strengthened.

The bulk of any financing requirements will be met by the private sector in one way or another, but recent events have increased the perception of risk among lenders. When, in particular, the heightened perception of risks inherent in political instability is added to the already strained capacity of some countries to meet their debt service requirements, capabilities to borrow in private markets become increasingly circumscribed for a number of countries. Thus, for a growing number of borrowers, costs are likely to be higher and loan maturities shorter than they have become accustomed to. And this will occur at a time when borrowing needs are vastly increased, but borrowing ability not only from the lender's, but also from the borrower's point of view is shrinking.

For the non-oil developing countries as a group, debt levels have at least tripled since 1973. But, because prices for LDC exports also rose fast, debt service as a percent of exports has risen much more slowly: from about 14 percent in 1973 to perhaps 18 percent in 1979. However, with the higher oil prices, rising interest rates and further large additions to debt, energy requirements combined with

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debt service are likely to absorb about one-half of export revenues in the early 1980's. Averages of this sort, of course, mask widely differing situations, ranging from those where servicing of existing debt already has proven most difficult, such as in Turkey, Zaire, Zambia, the Sudan and those where the current debt and reserve positions allow further assumption of debt, such as Mexico, Taiwan and others.

For most countries, access to financing has been relatively easy over the past several years. Consequently, the bulk of drawings from the Fund has been from the reserve tranches and from largely unconditional facilities, such as the Compensatory Financing Facility, which helps bridge temporary export shortfalls. In fact, during 1979 repayments outnumbered borrowings from the Fund so that loanable Fund resources actually have increased. At present, according to U.S. Treasury estimates, the Fund has a lending ability of perhaps $13-15 billion in usable currencies[2/] from its General Resources Account and another $17 billion under the General Arrangements to Borrow and the Supplementary Financing Facility (SFF). This may appear ample for the moment. But, the SFF is to be phased out by 1982. And the recent ability to repay Fund borrowings and to stock up reserves by borrowing in the private capital markets was clearly associated with excessive monetary ease in a number of industrialized countries in general, and in the United States in particular. However, faced with rising inflationary pressure at home and potential turbulence in the exchange markets abroad, monetary authorities

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2/ Those currencies likely to be in demand by member countries for financing purposes.

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almost everywhere currently aim to hold down credit expansion. And in many cases, governments have announced their determination not to accomodate the recent oil price increases by monetary ease. Accordingly, if governments are successful in controlling monetary expansion, the over-abundance of liquidity in world financial markets should disappear and, this in turn, should induce a greater use of the IMF's conditional financing facilities.

Given the size of the prospective financing needs and the recent liberalization of access to the various Fund facilities, increased recourse to the Fund could well strain its resources before long. Failure to provide adequate resources now, could lead to a patchwork of temporary, hastily constructed facilities that are not likely to meet requirements as efficiently as would the permanent facilities of the Fund. In addition, in these times of uncertainty and strain on international co-operative efforts, it is even more important than ever that the Fund's resources not be under threat of being pre-empted by possible drawings by one or two large industrial nations.

Even with the larger amounts available through the IMF, Fund financing can only be a complement to private sector financing, and a relatively small one at that. But, its contribution could be crucial. The lesson to be drawn from the recent financing and adjustment difficulties of a number of countries such as Turkey, Peru, Zaire, Jamaica and others, is that belated stabilization efforts are costly both in economic and political terms. It is a fact that in a number of cases bank financing has been available too readily and that some countries have gone to the Fund only after a

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crisis situation had become apparent and other sources of financing had dried up. Of course, banks need to evaluate lending risks properly, but it is not reasonable to look to them to impose policy conditions on recipient governments. Governments are sovereign entities and such interference would be wholly inappropriate. In addition, it would require joint exercise of pressure by the banking industry, which surely would not be desirable.

Nor is it reasonable to assume that the Fund can or should force a member government to subject itself to conditional financing. First, this implies the exercise of supra-national powers the Fund does not possess. But, more important, stabilization policies cannot be successful unless governments are convinced of their necessity and back them fully. The unfortunate fact is that most governments faced with politically and socially difficult problems prefer to put action off as long as possible. Under these circumstances, problems tend to become increasingly intractable and solutions more and more difficult to effect. Unfortunately, economic mismanagement is not like the common cold which can be cured more easily once it has developed into pneumonia. Nor can those who prescribe the cure be held responsible for the illness or for the bitterness of the medicine.

The stabilization programs worked out by the Fund in conjunction with member governments are a crucial part of any correction of payments difficulties that are not of a temporary nature. The economic framework within which these programs are developed presupposes that economies will

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respond to price and profit stimuli. Thus, the freeing of the economy of restrictions earlier imposed to supress the symptoms of the consequences of economic mismanagement. This involves adjustments of the price mechanism, including the exchange rate, and control of credit expansion, in particular to the public sector. Although this approach has been variously criticized, recent economic research tends to support these orientations.

It is true that economic adjustment often hits those hardest who can afford it least. But it is equally true that the consequences of inflation and misallocation of resources will tend to affect the economically and socially disadvantaged even more. Economic stabilization programs, as they attempt to return economies to a sustainable growth path, may temporarily interrupt the growth of real incomes and at times actually produce a fall in real incomes. But allowing imbalances to persist, will progressively undermine productive potential and thereby permanently reduce the potential for greater wellbeing.

This does not mean that corrective measures should not be fashioned in such a way as to mitigate hardships, particularly for those least able to bear them. But, realism also dictates that those economically most advantaged not be penalized too heavily, since they have the option to shift both their wealth and their productive capacity abroad. The unfortunate fact is, that resources are not limitless, while expectations are. And the success of any stabilization policy depends

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upon the acceptance of that fact, as Prime Minister Manley of Jamaica pointed out when he said, "We have now come to the point where to go forward the country has to produce more. We cannot live better unless we go through a further period of sacrifice, like a family pulling in its belt, even though it is hard -- and what we could spend on living (now) we have to put into production so that the nation as a whole can move to a higher standard of living (later). When you look at the budget and of what it can do, it is exactly like a quart bottle. If it is the size of a quart you can get a quart, you cannot get a gallon out of a quart bottle. If you want a gallon than you have to get a gallon bottle and no amount of propaganda can change it. These are the hard facts."

These hard facts are even more difficult to cope with in an environment of international monetary strain. And the potential for strain has increased significantly not only by the re-emergence of large investible OPEC surpluses, but also by the desire of official holders of financial assets to diversify their portfolios. The official international community is focussing its search for a way to smooth this diversification process on the proposal for a substitution account in the IMF. Under this proposal official holders of dollar-denominated assets would be able to swap some portion of these holdings for SDR-denominated securities. The major advantages cited in favor of this proposal are: (a) that it would allow reserve asset diversification to proceed without disrupting the market; (b) that it would result in an SDR-based system rather than in a multi-currency system; and,

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(c) that it would move the SDR toward the center of the international financial system.

In reality, however, the choice no longer is between either a multi-currency reserve or an SDR system. A multi-currency reserve system is already evolving. The DM, Yen and Swiss Franc component of official holdings of reserves (to the extent that it can be measured) has risen appreciably over the past several years, and this process has been accelerating in recent months.

The bulk of official reserve assets apparently is being invested with an eye both to obtaining the highest possible returns and to match asset to liability structures. Accordingly, SDR-denominated securities may be attractive mainly to those monetary authorities who in any event do not constitute the volatile segment among asset holders.

Recent attempts by the private market to issue SDR-denominated securities have not met with any significant response, indicating that current investment objectives do not favor them. Finally, the substitution account as currently envisaged would not meet the major requirements of high liquidity and relative anonymity stressed by a significant number of official reserve asset holders. Thus, the initial size of the proposed account -- some SDR 50 billion may be realistic in terms of the probable demand, but is totally dwarfed by the size of existing official portfolios and even more by the projected OPEC reserve accumulation.

While the substitution account proposal seems not adequate to deal with the problem of the portfolio balancing objective of official asset holders, the negotiation process

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could become extremely costly in political terms. For example, the question of the sharing out of costs and exchange risks is an exceedingly difficult one to solve and could absorb a fair amount of political capital. Furthermore, general acceptance depends upon the support not only of the reserve rich, but also of the reserve poor. In this respect, the developing countries, rightly or wrongly, are likely to construe the proposal as a willingness of the international community to "bail-out" the United States, while it has been unwilling to move similarly to fund LDC debt. Proposals to use a portion of the Fund's gold as backing for the Substitution Account, at a time when Fund auctions -- the source of finance for the Trust Fund -- are to end, would further add to this perception. At a minimum, the pressure to link new SDR allocations to aid is likely to increase. This would inhibit the proper functioning of the adjustment process -- as it would tend to postpone adoption of needed adjustment measures-- while it would not enhance the role of the SDR as the main reserve asset. One is led to ask, at a time when international cooperation is at a premium as many countries appear to be adopting increasingly self-centered attitudes and when the international financial system faces serious potential strains, whether political capital and the energy of high officials should be diverted to this particular issue.

Energies should be focused on the difficulties of recycling funds from surplus to deficit countries and, of assuring smooth and adequate adjustment. The banking system will play a dominant role in the recycling process, but this

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may need to take less traditional forms. Banks, particularly in the United States, have to look increasingly to maintain appropriate capital/assets ratios and together with the supervisory authorities have a heightened awareness of the risks associated in concentrating lending in particular countries or sectors. Thus, there may be limits to the traditional way of intermediating surplus savings. The industry, however, has proven to be innovative and will find ways and means, possibly through brokerage-type activities, of bringing borrowers and lenders together.

To assure that lending to any particular customer does not become excessive, information flows regarding the balance sheets of borrowers need to be improved. The work currently proceeding in the BIS, the World Bank, and also the information provided through U.S. supervisory authorities, is helpful in this respect. But more needs to be done. If countries wishing to borrow would make available information on their overall financial condition, of the type now provided by corporate and private borrowers, would-be lenders could provide a smoother flow of financing and borrowers could exercise better control over their financial condition. On the whole, this would provide a better basis for earlier, and therefore easier and more effective adjustment. Even with this information flow, as we have learned, Chrysler-type situations cannot be avoided, but their number at least can be limited.

In addition, IMF lending, particularly through the longer-term facilities, could be more effective if the current process of mutual co-ordination with the multinational development institutions could be strengthened. Finally,

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any arrangements that attempt to smooth the funneling of financing from surplus to deficit countries cannot be successful in the absence of sustainable growth of world markets and reasonable price stability. This largely depends on the domestic policies pursued in the major countries of the world economy, but it does make the surveillance function, and, therefore, the vitality of the IMF increasingly important. It is for these reasons that I urge you to support the enactment of HR 5970, and to reject the amendments that circumscribe the ability of the Fund to impose conditionality on drawings in the upper credit tranches.

Chairman NEAL. Professor Murphy.

STATEMENT OF PROF. J. CARTER MURPHY, SOUTHERN METHODIST UNIVERSITY

Professor MURPHY. Thank you, Mr. Chairman.

I, too, like my colleagues at this table, am grateful for the opportunity to present my views to the subcommittee. I think nonetheless, that my comments will take a somewhat different line from those that the others presented, because I want to dicuss some of the issues that are placed before us on a somewhat different level.

While I want, at the outset, to assert my own devotion to the principles of international monetary cooperation and to a free and open international trading and investment system, I am not attracted to the view that the resources of the International Monetary Fund should at this time be enlarged. It seems to me that we are failing to take the opportunity to look at the IMF in a new light, even after having fundamentally revised its charter. The IMF, it seems to me should be seen as having new missions to perform as compared to its missions in the past.

Its fundamental prior mission was, as you will recall, the financing of temporary international payments imbalances. For many years it was hoped that all countries would be able to follow monetary and fiscal policies that would achieve full employment and stable prices and that this would make the required amount of financing among countries reasonably small, even with fixed exchange rates and in the context of a free and open trading system. That optimistic view of the role of the International Monetary Fund, however, turned out to be unrealistic, and we have abandoned the effort to maintain pegged exchange rates by transitional balance-of-payments financing. Our image of the importance of such financing is, I have no doubt, part of our heritage from the 1930's, the years of demand-led depression throughout the world. Since that time, we have been enormously concerned that countries

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never be forced to import depression from abroad—that is to say, we have been concerned that balance-of-payments deficits should be financed.

It seems to me that neither of the missions I have alluded to—the mission of insuring that countries don't import depression and the mission of maintaining fixed exchange rates—is any longer one to which the Fund need be devoted. Rather, the Fund should turn toward the surveillance of the exchange-rate system, surveillance of the financial practices of countries that are members of the Fund, the codification of rules, the mediation of disputes, and in general the task of making the flexible exchange rate system a workable one. Financing, while not unimportant, is not the central ingredient of that task.

I suppose the chief point I want to emphasize is that financing of balances of payments, like any financing, is inflationary. Inflation is, of course, always homemade for a country in the sense that the inflation in a given currency depends fundamentally upon the supply of that currency, a supply which is governed by national institutions. International financing, nonetheless, enables countries which are undergoing relatively high inflation to escape the domestic consequences, in some degree, of their inflationary policies. That is to say, international financing prevents the depreciation of the currency which would have otherwise taken place, and it drains off some of the domestic money supply which has been generated. In these ways it enables the country to escape the results of its policies. Needless to say, the inflation that one country escapes, however, is imported by another country. That is to say, the forces find their way into the international community.

I personally believe that we should be looking toward a system in which countries must feel the brunt of the inflationary policies that their political systems have chosen. Only by putting the full cost of inflation on those who create it can we hope to change the policies that are responsible for it. This implies, in my view, that exchange rates should be, in general, more flexible rather than less.

Not only is the financing of payments imbalances inflationary, it tends to misallocate resources by failing to permit the exchange rates fully to reflect financial conditions within countries. It tends to postpone difficult adjustments, a matter which earlier speakers have already addressed.

In general, there is ample incentive for the use of financing as opposed to the use of policies leading to adjustment. Countries whose currencies are strong and tending to appreciate wish to finance their balance-of-payments surpluses, by and large, essentially as a protectionist mechanism in order to preserve the competitive position of their international trade-related industries. Countries with balance-of-payments deficits often have a willingness to finance those deficits to avoid the inflationary consequences of not doing so. There can hardly be doubt that we have financed balance-of-payments deficits very heavily—perhaps too heavily—in the 1970's.

I would hasten to say that we shall also have enormous financing available for the financing of balance-of-payments deficits in the 1980's. Concern is often expressed, particularly from the banking

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community or from others, that private financial institutions may or may not be able to finance fully the balance-of-payments deficits which might emerge in the decade ahead. I submit that I doubt this to be the case.

The international banks, by and large, have been very careful in the construction of their balance sheets in recent years. In general, for example, they have done a reasonably close job of matching the maturity of their liabilities to the maturity of their assets, so they are not exposed in an unreasonable degree to liquidity risks. While for a time the capital structure of banks deteriorated, and this resulted in a few bank failures—especially in 1974—since that time banks have been much more careful about their foreign-exchange risks, and they have strengthened their capital structures, typically by borrowing with debt that is subordinated to the rights of the depositors and by reinvestment of earnings.

In short, the banks have put themselves in a stronger position than ever to continue the financing of balance-of-payments deficits in the world, and that they will have the facilities to do so in large amounts can hardly be doubted. If, indeed, existing banks in the international community should fail to provide the intermediation services that are demanded in the market and that are creditworthy, the services will surely be provided by still other banks which will open branches in London and Hong Kong and enter upon the business which has been left untended.

We have been told again and again that if oil-importing countries do not have the means to finance their current accounts, particularly their oil-related deficits, they will turn to "beggar my neighbor" protectionism. In fact, there are other avenues of adjustment. And we can have some confidence, I think, that governments will be resistant to the protectionist pressures which they feel from some of their constituencies.

Among the avenues of adjustment are these. The oil-importing countries can disinflate. They can also pass on energy prices to their residents in a degree that has scarcely been done in most countries—a fortiori in our own, I may say. And oil importing countries other than the United States can depreciate relative to the dollar.

But even more important, I should like to speak to the issue which was a hypothesis of Professor Dunn's comments—namely, that without excessive financing in the markets, the oil exporters will also have to make adjustments. We have hardly to date, after all, imposed any adjustment burden on the oil exporters; we have stood ready to finance purchases of oil at the prices which they demanded, almost without limit, and they have naturally taken advantage of that financing and have raised their prices again and again.

Without financing, clearly the oil exporters would have had to make some other adjustments themselves. Those adjustments might have taken the form of reducing producting, and this has been the great fear in the West. But some oil exporters surely would have undertaken increased bilateral financing of their surpluses or they would have been in a less advantageous position with respect to price. From my point of view, either of the latter forms of adjustment would have been very helpful to the interna-

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tional community and, in particular, to the interests of this country.

We are given estimates of large balance-of-payments deficits which lie again before us in 1980 and 1981. I must admit that I am not impressed by those estimates because a country doesn't run a balance-of-payments deficit unless the financing is available. In a world of flexible exchange rates, our balances of payments, in an overall sense, do balance. One cannot then estimate such deficits, assuming the financing to be available, and then assert that the financing which we have assumed is the financing which is required. Rather, we must look for patterns of adjustment and then work toward those patterns which are optimal or which involve least social cost.

The IMF's additional financing is sometimes justified on the grounds that the Fund has to have financing in order to impose its conditionality upon its borrowers—with the presumption that this is a healthy phenomenon. I must admit that this, also, is a somewhat strange argument to me. For the IMF imposes conditionality, but it also makes loans at less than market rates of interest. And if countries come to the Fund for loans, it must be because they find the Fund a less onerous lender than the market in general. Or, alternatively, they come to the Fund because the banks have urged them to make their peace with the Fund before the banks continue their own financing. In that case, the leverage of the Fund is enormous on the borrower, whether or not it has its own financing to provide.

The issue is also raised as to whether or not the IMF should be an aid institution to help the poorest in the world. Here I agree completely with today's earlier speakers, that we mix the motives and we mix the instructions we give to a financial institution like the Fund if we ask it to take care of the welfare of the poor, within countries and between countries. We have other institutions which do that job—not always as well as we would like, but which are available for that job—and I urge that the IMF's directives and its guidelines for action not be mixed on those grounds, for otherwise we shall not get important functions carried forward which only the IMF can do.

The whole approach of predicting balance-of-payments needs at predicted rates of inflation and then of insuring that such financing is available seems to me to be symptomatic of the inflationary problem with which this country and the world wrestles. I can't help but say that, scarred by a depression of 40 years ago, we have tried to insure since that time that there is never any restraint on markets from the demand side. In such a posture, we have placed ourselves into the worst worldwide inflation that is recorded with good economic data. We have damaged economic progress, redistributed wealth, and set group against group and nation against nation. I urge that we begin a course back towards sanity.

In the few moments left, let me speak to the subject of an SDR substitution facility.

What is involved is a shifting of claims that are held by foreign governments, in dollars, toward claims that are designated in SDR's and which become claims on the IMF. The IMF is then interposed between the claimants and, primarily, the United

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States. The pressures that move us in that direction are: One, a desire by some countries that have dollar claims in large amounts to have a portfolio that's more diversified against dollar exchange-rate risk; and two, fears by the U.S. Government and officials at the IMF and elsewhere that countries will redistribute their portfolios and, in the process, bring havoc to the foreign-exchange markets. I should like to make several comments about the alleged threat and the solution. To begin with I should like to remind you that there is, after all, a good deal of stability in the present structure. We do not have a situation in which we can expect that countries are going, in an irresponsible way, to begin shifting their funds from one currency denomination to another.

Many of the claims which are in question are claims which have arisen as a result of interventions in the foreign-exchange markets out of a wish by governments to resist the appreciation of their currencies. To the extent that those currencies remain strong, we can be reasonably certain that those countries will not reverse their intervention process. That is to say, they will not take steps not to cause their currencies to appreciate, which earlier they avoided. Otherwise there are countries which have come to hold dollars because of the usefulness of the currency as a transactions and investment medium. Those countries, too, find themselves locked into the dollar in some degree because of the very size of their holdings; in any major effort to redistribute those holdings among currencies they will move the exchange rate against themselves and therefore impair the value of their remaining holdings.

Another element giving stability to the system is that in the short run there is no good alternative to dollars as an asset for most countries to hold. I may say that that is not a condition which we can expect to survive forever, because if, indeed, there is a demand for an asset alternative to the dollar, sooner or later the banking community or others will provide it. That is, the banks will provide a new cocktail currency that is well adapted for the curcumstance, or indexed accounts or something to which countries in time may shift.

But in the short run, there is no good alternative asset to hold. With respect to deutschmarks, for example, there is not a deep market for the currency. The same is true for Swiss francs. Both of those countries, in addition, take steps to try to prevent the development of an external market for their currencies because they don't want the responsibilities that go with having one's currency serve as a reserve currency.

If there is some degree of stability in the present system—and I don't want to overemphasize it, nor do I want to underemphasize it—there are also some risks in creating an SDR substitution facility. In particular, governments of countries whose currencies continue to appreciate vis-a-vis the dollar and who have some incentive to continue to accumulate dollars to resist that appreciation, primarily as a protectionist device, now would be rid of their so-called dollar overhang, and they therefore might be more willing to intervene—a step which is usually neither in the interest of the United States nor in that of the wider international community. Similarly, governments of oil-exporting countries, in filing their claims on an international institution might escape the overhang

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of dollars, which they now feel, and, as a result, the U.S. Government would regrettably be relieved of some pressures to pull back from inflationary policies.

I want to point out here that if the United States acquiesces and moves in the direction of an SDR substitution facility, we do give away what has been our trump card, a half-hidden card perhaps, but a trump card in our negotiations with the oil-exporting countries. It is that they have had little alternative but to build up their claims on the world in the currencies of the countries who were their importers. And that buildup of currencies, those bank balances, were always a potential hostage to steps which countries like the United States might take. We of course took, in the case of Iran, the step of blocking the country's dollar assets only 2 months ago. Obviously, our other creditors are now more fearful, more unhappy, more certain that a degree of risk exists for them in that connection that did not exist before. But I think we should seriously question ourselves as to whether or not that is a bargaining weapon which we are now prepared to forego.

There are a number of technical issues, which I have referred to briefly in the paper I have submitted concerning the creation of an SDR set of accounts. The big issue, I believe, and the issue we must ultimately address, is whether we are undertaking to build a world where the international monetary system is based on the dollar, or whether we undertake to build a world which is based on an asset such as the SDR.

The world has developed a dollar-centered system since World War II, and the dollar now plays important monetary functions for a great number of international transactions. That system, I think we all recognize, is jeopardized by the profligacy of this country's fiscal and monetary policies, policies which have caused the dollar continuously to lose its purchasing power, domestically and internationally.

If that system—a dollar centered system—cannot be rescued, then we must seek an alternative. And, if we are seeking an alternative, the SDR provides a reasonable candidate. Much, however, is to be done before the SDR can serve many of the functions in the international community which are now served by the dollar.

Among other things, the SDR would surely have to become a currency which could be held privately, as well as by central banks and governments. Banks would provide intermediation in accounts which were designated in SDR's. The IMF would generally have to take on the preogatives and role of a central bank, a supranational central bank. We are a long way, by and large, from that kind of a circumstance.

The decision by us to support such a route—namely, turning toward the creation of an SDR-centered system, while abdicating international responsibility for a dollar-centered system—will lead us through a period of great travail.

I might even suggest that if we are deeply concerned about the dollar overhang and the continuance of U.S. petroleum deficits, we would do better to use our gold stock, trading one mineral for another, than to move blindly toward the creation of an SDR-centered system until we're aware of its consequences.

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The course of action I would prefer to see would be one in which the United States accepts responsibilities for maintaining the value of its money, internally and externally. This is, of course, essentially a matter of avoiding Government fiscal deficits and limiting the growth of the money supply. If we're successful in doing this, the problems of the international monetary system will take care of themselves.

Thank you.

[The prepared statement of Professor Murphy follows:]

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Statement For The Subcommittee On International Trade, Investment And Monetary Policy Of The House Committee On Banking, Finance And Urban Affairs, February 7, 1980

Concerning

Proposed Authorization Of An Increase In The U. S. Quota In The International Monetary Fund.

By

J. CARTER MURPHY

PROFESSOR OF ECONOMICS

SOUTHERN METHODIST UNIVERSITY

DALLAS, TEXAS

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Mr. Chairman, and other members of the Subcommittee:

I am grateful for your invitation to present my views on the issues involved in the proposed authorization of an increase in the U. S. quota in the International Monetary Fund.

I want to say at the outset that I am deeply devoted to the goals of international monetary cooperation and free and open international markets for trade and investment with which the IMF has been associated from its beginning. I believe, too, that a viable IMF is an important part of the institutional structure we shall need in the years ahead. Nevertheless, unlike many of those whose testimony you will hear, I am not led by these views to conclude that the Fund should at this time be enlarged.

The IMF's role in contributing to balance of payments financing was conceived in a period in which fixed exchange rates were thought to be an appropriate part of international monetary arrangements. To keep exchange rates fixed, while trade and payments restrictions were avoided, there had to be financing facilities. The provision for balance of payments financing in the IMF's design was certainly also linked to the fears of widespread purchasing power deficiency that were inspired by the experiences of the 1930s. We wanted to be sure that no country ever had to import depression. The hope, however, that governments of the industrialized countries could harmonize their demand policies around non-inflationary, full employment levels and make

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fixed exchange rates feasible proved unrealistic; and the view inherited from the 1930s that governments should usually take risks of inflation to avoid risks of demand deficiency surely should now be questioned. I believe that in the present nationalistic and highly inflationary environment the IMF should be focussing on new missions. The Fund has an enormously important role to play in surveillance of the exchange rate and other financial policies of its members, in the codification of internationally acceptable financial practices, and in the mediation of disputes. Extensive balance of payments financing, however, should no longer, in my view, be regarded as the central part of its responsibilities. Official balance of payments financing contributes to the inflationary milieu that presently distorts economic and political decisions throughout the world; more to the point, additional facilities are unnecessary as a supplement to what the private markets and individual governments can be expected in coming years to provide.

There has been, and is likely to be, I believe, entirely too much financing of balance of payments deficits. It is, I think, agreed that the private international financial markets functioned with remarkable effectiveness during the 1970s in "recycling" funds in enormous amounts from countries with balance of payments surpluses to countries with deficits. In addition, there has been bilateral lending among governments, both intermediate term and as a result of exchange market interventions, and the intermediation activities of the international organizations, including the IMF, have been very large.

Looking forward to the 1980s, I see no reason why the international banks cannot sustain and expand their lending levels. Most of the large banks have limited their exposure to liquidity risk by matching in substantial degree the time maturities of their international assets with those of their liabilities--that is, they have avoided borrowing short to lend long. They have also,

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since 1974, rather carefully covered their exchange risks. Furthermore, as their liabilities have grown, the banks have added to their capital stock and reserves to safeguard their solvency. In these circumstances, their ability to provide intermediation services has probably been strengthened, rather than weakened, by their growth to date. And if private institutions presently in the market should prove reluctant to provide intermediation services for which there is a demand, new market entrants in the form of banks not now significantly engaged in international activities, will certainly come forward. Governments of industrialized countries which run bilateral or global balance of payments surpluses can also be expected to help sustain their surpluses by formal lending and by exchange market purchases of deficit country currencies Altogether there will be enormous financing in the years ahead without actions by the IMF further to supplement the market.

Indeed, the result of the financing will be that many countries that lead the way in inflation or that seek too long to suppress the consequences of changes such as the increased prices for energy will be able partly to escape the consequences of their choices by exporting inflation to others. They will escape inflation in the degree that financing prevents depreciation of their currencies from fully reflecting internal monetary and price developments and because a part of their internal monetary expansion is drained away in the form of payments to abroad. Countries that would otherwise have been less inflationary will import this inflation.

In short, financing of balance of payments current account deficits contributes to worldwide inflationary forces by allowing more profligate countries to export the consequences of their policies to others and to escape, in some degree, the immediate consequences of their policies. I am of the view that imposing the burden of inflation at the place of its origin, where decisions must be made to reverse biases in favor of inflationary policies, is an essentia

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step we must take if we are to slow the global inflationary tide in which we are caught up. The currencies of more inflationary countries should be allowed to depreciate, and currencies of less inflationary countries should appreciate.

Not only does excessive financing of international payments imbalances contribute to world-wide inflation, however, it contributes to sustained disequilibrium in markets and hence to misuse of resources. International lending is essential to provide trade credit and investment capital, to fund private and public accumulation of transactions balances in external currencies and as a manifestation of private, exchange-rate-stabilizing speculation. Official lending that goes beyond these needs—which is to say, official lending aimed primarily at preventing exchange rate adjustments—generally "misaligns" the exchange rates. In view of the great disparity in the monetary and fiscal policies that we now observe among countries, exchange rates that are made too stable by balance of payments financing are misaligned. In countries with overvalued currencies the import competing and export industries gain unjustifiable protection, and in countries with undervalued currencies the trade related industries are inappropriately exposed to competition. In both overvalued and undervalued currency areas, resources are inefficiently used. I suggest that the resistance that many governments have offered to appreciation of their currencies in recent years is a contemporary form of a protectionist trading policy.

If I may turn to a somewhat related matter, we are told again and again that the oil-importing countries of the world must find the means to finance their needs at the prices for petroleum that are dictated by the oil-exporting cartel. But what determines the prices oil-sellers "dictate?" Surely those prices are influenced by the importing countries' ability to pay in the assets

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that the exporters desire. In fact, the flood of dollar-denominated credit available for financing international petroleum sales has resulted in the OPEC cartel's never having been required to face up to the problem of allocating a shrinking world demand among competing suppliers. Oil exporting nations have generally been able to sell all the oil they wanted to produce at ever escalating prices. Without belittling the real difficulties of economic and social adjustment to circumstances in which energy is bound to be relatively more expensive, I conclude that our financing policies have protracted the problem of world payments imbalance that is due to increased petroleum prices. With less financing available, not only would oil-importing countries have had to hasten their adaptations to the new circumstances, but oil-exporting countries would have had to choose among (1) lower production and exports (2) engagement in bilateral financing of their sales, and (3) smaller price advantage. From my point of view, the second and third of these avenues of adjustment would have been welcome additions to the international scene.

We are told in estimates prepared at the OECD, at the IMF, and in our own government that increased "need" for financing deficits and surpluses in countries' international current accounts lies ahead, and that for this reason increased IMF capability to finance is required. But this is a very peculiar argument. In a world of managed floating exchange rates, the current account deficit that any country experiences is necessarily equal to the financing available. Hence, in predicting current account imbalances, one necessarily starts with an explicit or implicit assumption concerning available financing. To then discover that the financing "need" is equal to the financing assumed is not especially helpful.

The correct intellectual approach to the problem, of course, is to assess the adjustment avenues available in the system and then to attempt to choose an

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optimum multivariate adjustment set. The adjustment dimensions may include disinflation in some countries, relative price changes (including increases in the relative price of energy) in most countries, and exchange rate changes--along with some financing of residual balances.

Advocates of ever growing financing capabilities, however, raise the spectre that if oil-importing countries are unable to finance their projected current account deficits, they will individually turn to policies that reduce the demand of each nation for the goods of the others. It is said that they will induce unemployment, raise barriers to imports, and engage in competitive currency depreciations, all the while reducing very little the aggregate deficit of the oil-importing group with the oil-exporting group.

This seems to me unnecessarily pessimistic and an example of the myopic fear of disinflation that has too long characterized public policy decisions. Surely a measure of disinflation need not be unwelcome in some countries; and the prediction that countries will turn to dog-eat-dog protectionism is exaggerated. In 1977-78, amid repeated warnings of renewed protectionist dangers nations found it possible largely to complete the Multilateral Trade Negotiations One might, of course, argue that the measure of success in trade liberalization obtained here was only possible because of the availability of ample financing for world trade and, perhaps insofar as this country is concerned, because of the decline that occurred in the value of the dollar. Yet, one need not always despair in order to be realistic. Many governments are aware in the 1980s of the value of maintaining an open international trading system and can be expected to offer resistance to internal political pressures for trade restraints. Furthermore, I deeply believe that if there should be a slowing of international financing, exporters of petroleum as well as importers would find it to their

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advantage to contribute to an adjustment. And if, in the absence of generous balance of payments financing of the petroleum trade, the exchange rates of some countries should depreciate relative to the dollar, the chief currency of settlement in that trade, would the appreciation of the dollar be an undesirable thing? An appraisal would take us far afield, but for this country, it would involve weighing the advantages of the slowing of inflation measured in dollars against the disadvantages of a reduced competitive position for U. S. goods in world markets. It is a trade-off that would reverse the trends of recent years when we have followed policies that insured enough dollar financing for internal and external trade to induce a declining effective dollar exchange rate.

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Another argument for IMF financing that is strange to me is the argument that the IMF needs lending capability in order to impose its conditionality upon official borrowers, inducing them to pursue less profligate financial policies. Can stringent loan conditions (in association with below market IMF interest charges) induce better behavior by borrowers than the necessity for borrowers to turn to the still more demanding open market? All lenders of course impose explicit or implicit conditions on their borrowers, and that the IMF imposes less onerous overall conditions than would other lenders is a chief reason any borrower turns to the IMF. Countries may also turn to the IMF, however, because banks have required it, having found IMF participation useful in a financing package aimed at restoring a country's financial credibility. The IMF becomes then the chief negotiator and monitor of performance standards in the borrowing country on behalf of the international lending community. What is of interest to the question at hand is that if the bankers continue to choose in this way to ask the IMF to be the enforcer of lender conditions, and the IMF accepts the role, the Fund will have great leverage on the policy choices of borrowing governments regardless of its own financial resources. In the degree that bankers make use of IMF participations and monitoring, the IMF will need less financing capability of its own to make its advice to borrowers persuasive.

Turning to another dimension of our subject, there is in the minds of most of us deep concern for the special problems of the world's poorest peoples, among whom development programs must be sustained year after year and where emergency aid is from time to time required. This concern leads to suggestions that the Fund give greater attention to these matters. I must say I believe that the use of the IMF for such purposes is generally

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the choice of the wrong institution. The IMF's design provides no facilities for the evaluation and selection of developmental projects or programs. And past use of the Fund for "rescue" programs has required the proliferation of special "facilities" where it remains impractical to pinpoint assistance to the countries and the circumstances that are, at any moment, arousing the world's conscience. In short, the Fund's design for financing is oriented to balance of payments needs, and the use of balance of payments criteria in the allocation of funds is neither efficient for the identification of successful development efforts nor for the pinpointing of emergency consumption needs. The World Bank Group of institutions, the regional development banks, and bilateral and multilateral relief and assistance agencies, both private and official, are better suited for meeting most of the special needs of developing countries.

Generally, therefore, I am not deeply sympathetic to the plea for further enlargement of permanent IMF resources at this time. While it is true that the IMF's permanent financial base in the form of quotas has declined relative to the value of world trade almost steadily since the Fund's inception, the access of Fund members to balance of payments financing through Fund activities has not at all declined in the same degree. The various special facilities in the Fund--the Compensatory Financing Facility, the Extended Fund Facility, the Buffer Stock Facility, the Supplementary Financing Facility, and the Trust Fund--are all in some degree additional to the access to the Fund that was provided for in the Fund's initial design of quotas and drawing rights. Furthermore, the Fund will, by 1981, have allocated 21.3 billion of SDRs to its members while relaxing the reconstitution requirements that limit the use of these assets.

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It is my view that we have acquiesced in excessive financing between countries as well as within them throughout the 1970s with the result that we experience inflation of a virulence that, as a worldwide phenomenon, has no recorded peacetime or wartime precedent. Out of an exaggerated fear that the depression, unemployment, and tendency to trade restrictions of the 1930s will recur, we have unleashed an inflationary process that now impairs productivity, cruelly redistributes wealth, and sets group against group and nation against nation. The process is, I suspect, significantly more damaging to the world economy than a modicum of trade restrictions would have been, and it will be much more difficult to reverse. At some point we must reassess our approach to the risks of inflation versus the risks of deficient demand.

If you will permit me to turn to a somewhat different line of comment, I would like to address a selection of the issues associated with the idea of an SDR Substitution Facility in the IMF. It is a facility in which interest has been renewed because of the desire of some governments to diversify their foreign exchange holdings away from the dollar and because of a desire on the part of officials in the U. S. government and the IMF to minimize the temptation for governments to take steps that would be disruptive to the foreign exchange markets. The concern of many governments with the way their reserves are held has of course been increased by the recent U. S. action of blocking Iranian official assets. Other governments do not like what they must now regard as greater exposure to similar treatment.

It is possible to forget the stability that is built into the present system of things and hence to overstate the risks that the monetary system faces through possible massive shifts of funds among currencies. We must remember that the dollar accumulations of foreign governments stem from

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incentives some of which are no less strong now than they were in the past. Furthermore, without an SDR Substitution Facility, there is a shortage of good candidates among assets that might replace the dollar in reserve portfolios.

Dollar accumulations by foreign governments and central banks have taken place chiefly as a result of two motives: (1) governments' desires to resist appreciations of their own currencies against the dollar, leading to market interventions; and (2) desires by governments of oil exporting countries to hold a currency that has great utility as a medium of exchange and an investment medium. Both of these motives to hold and acquire dollars still exist, although from time to time in diminished form, and both therefore restrain what might otherwise be easy government decisions to seek greater portfolio diversification through a sell-off of dollars in the foreign exchange market. Countries which have acquired dollars through exchange market intervention are not likely to reverse those interventions and abandon their exchange rate goals insofar as their currencies continue to show exchange market strength. And oil-exporting countries have become increasingly locked into their dollar holdings as their accumulations have grown, since any attempts by them to reduce their holdings, or rates of accumulation, risk reducing the value of their outstanding balances. In brief, the size of the U. S. as an economic entity and the size of some countries' dollar holdings make the dollar exchange rate against other major currencies important to those large holders. Any of them would suffer a cost if it undertook a significant sale of dollars in the exchange market.

On the matter of the unavailability of alternative assets to hold, if in the long run an official demand for alternatives continues and is not satisfied by action through the IMF, one can be sure that banks will

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design and sell to governments attractive assets in the form of "cocktail" currencies or indexed accounts. Lack of supply of alternative assets cannot therefore be a long-term force compelling the holding of dollars. But for the short-run, it is a force that is stabilizing to reserve portfolios.

On the other side of the ledger, there are some risks to the monetary system that will be increased by the creation of an SDR Substitution Account. One is that if countries with low internal rates of money expansion perceive that the cost of protecting their international trade related industries by exchange market interventions is reduced as a result of escape from what they may now regard as a dollar "overhang," they may be tempted to intensify such interventions. And likewise the U. S., if it is relieved of potential exchange rate pressures, may still longer postpone the anti-inflationary efforts which are long overdue in this country. These results would not be in the interest of either the United States of the world economy.

Another risk is that oil exporting countries might become more immoderate in their oil pricing policies. In accepting an arrangement that shifts the oil-exporting nations' short-term claims on the world into an international organization, the U. S. and other oil-importing nations give up what has until now been a half-hidden trump card in their relations with the oil exporters, namely the potential for holding the accumulating financial claims of the oil exporters hostage. The United States must consider whether or not it wishes now to accomodate the oil exporters' desire to escape this potential.

Numerous technical questions arise in the design of an SDR Substitution Facility, for SDRs have different properties than dollars as reserve assets, and both the U. S. and the IMF have different needs as debtor-creditor agents as compared to those of the U. S. and the present holders of dollar claims. The usability of SDRs, for example, is at the present time still encumbered

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by a reconstitution requirement. (Countries participating in the SDR Account must reconstitute their SDR holdings so that their average holdings over moving five-year periods are not less than 15 percent of their cumulative SDR allocations.) Are governments which substitute SDRs for dollars to accept a reserve asset so encumbered, or is the reconstitution provision for these, or all SDRs, to be eliminated? Similarly, should the acceptance obligations of nations for SDRs (the obligations that give SDRs their value) be extended above their present limits, or made unlimited? What interest rate is to be payed on SDRs provided to members as a result of substitution, and who is to bear it? Is the interest rate that is payed on SDRs that are allocated in the usual way to be extended to SDRs provided by substitution? Where that interest rate is different from the average rate payed by the U.S. on balances due foreign official agencies (it is presently less), does the U. S. or the IMF make up the difference? Is the IMF to impose an interest charge on nations for the SDRs they obtain through substitution, as is done in respect of SDRs obtained through allocation, or are these SDRs to be treated differently? While answers to all of these questions have overall liquidity as well as international equity implications, there are other questions still more central to the discussion.

If present holders of dollar balances are reluctant to bear the liquidity and exchange rate risks of dollar assets held in the United States, who is to bear that risk in a Substitution Facility? Is the IMF to assume the risks by holding the dollar claims without further assurances? Or are new guarantees expected of the U. S.--for example, an exchange rate guarantee in which the U. S. undertakes to adjust its dollar obligations to compensate for any

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change in exchange market valuation of the dollar? Is the IMF to have no opportunity to balance its portfolio of currency holdings or to reduce them? Or, putting this question another way, is the U. S. government now to undertake to repay, presumably in some scheduled way with SDRs earned in international markets, the substantial liquid claims that foreign governments and central banks unilaterally accumulated in this country--or is the debt to be essentially frozen for the time being? What foreign claims on the U. S. are to be eligible for substitution? Will subsequent claims obtained by governments also be eligible? Is substitution a one-way street for the group of governments which might choose it? Is a "need" condition still to be applied to SDR use to prevent flight from, say, SDRs to a currency or gold?

In my view, all nations in assessing this and similar significant institutional changes, must look to the kind of international monetary system it is sensible to try to build. Since the Second World War, growing international use of the dollar as a unit of account, medium of exchange, and store of value, for both official and private transactions and holdings, has added greatly to the efficiency of world markets. If there is a reasonable outlook that monetary and fiscal management in the United States can become such as to keep the dollar relatively scarce, and hence valuable, in comparison with the currencies of other, more financially conservative trading nations, the world would do well to foster the wholesome evolution of a dollar-centered monetary system, taking advantage of monetary customs that already have wide acceptance. If, however, there is little hope for financial prudence in this country, then the dollar-centered system is doomed, and the search for a promising alternative must begin. In that circumstance,

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the SDR is a fair candidate. But for the SDR to serve important functions now served by the dollar, it would have to become a monetary unit held by the public, and the IMF would have to become a full-fledged supra-national central bank, regulating private bank intermediation in SDR-denominated accounts. We are a long way from that world, and between here and there certainly lies a great deal of monetary disorder since dramatic changes only occur as a result of extraordinary needs. A reassessment of monetary and fiscal responsibilities in this country that would stabilize the value of the dollar and make possible the preservation and development of an international monetary system centered on the dollar still appears to me to be a more promising line of development.

Chairman NEAL. Thank you, Professor Murphy.

I would like to thank all of our witnesses this morning. You've have been most helpful.

I would like to start by asking you a question that you have all touched on, I believe, on one way or another, but does not directly affect the legislation before us. That is the desirability of somehow getting the OPEC countries to make some direct loans or to enter into other financial arrangements directly with lesser developed oil-importing countries.

That is a very attractive alternative, except I do not know how to be a part in the encouragement of such a policy. Do you all have any advice on this, how we might find ways to inspire the OPEC countries?

Professor DUNN. Let me return briefly to my earlier comments. I think the OPEC countries behaved in 1974 and 1975 a little like a man who had always been poor and who has suddenly and unexpectedly became rich. The first thought of such a person is to preserve his capital, that is, to make sure he does not lose the new wealth. And like such a person, the OPEC countries invested very conservatively.

Now that they have been in surplus for 5 or 6 years and have piled up assets in rather large volumes, the OPEC countries ought to be willing to become a little bit more venturesome, that is, a little less risk-averse.

With regard to countries like Libya and Iraq, you cannot appeal to them on the basis of any broad interest. They do not identify their interests with ours at the present. With regard to Kuwait, the Emirates, and Saudi Arabia, it is a matter of making it clear to them that if the system falls apart or gets in very serious trouble, the kind of instability that will arise in many of these developing countries will threaten them as much as anybody else. As a result it is simply in their interest to protect the stability of the system, and that in order to do so they ought to behave a little differently now that they have been wealthy for more than 6 months.

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I do not expect the Libyans and Iraqis to do that, but I think the other three could be approached quietly and diplomatically on this basis and that over a period of time such efforts might have some effect.

Chairman NEAL. Of course, I think we have to assume that they are aware of their stake in the stability of the system.

Professor DUNN. They think we could encourage such awareness.

Chairman NEAL. And, of course, we were able to get good participation by some of the OPEC countries in the liquidity facility of the IMF.

So your suggestion is that we try to be more persuasive.

Professor DUNN. Yes.

Chairman NEAL. Yes, Ms. Junz.

Ms. JUNZ. If I might just add something to this—in contrast to the 1973–74 period, we find now that the lesser developed countries, which are not oil-rich, have become rather more critical of their brethren who are and are themselves putting some pressure on them to share some of this wealth with them.

To some extent I think, while I believe we ought to go the road of persuasion that Professor Dunn has suggested, prudence is dictated there, too, because if we have more and more bilateral, either grants-in-aid or investment-type streams between oil exporting and non-oil LDC's, we, of course, also have greater political pressure on the recipient countries. And to some extent I think, in a world that is becoming more bilateral and more devisive, the multilateral route should be the recommended route. For that reason, I believe the Witteveen facility was a better route than trying to persuade oil exporting countries to develop client relationship with non-oil LDC's such as is already occurring in the case of a number of OPEC nations.

Chairman NEAL. Do you recommend another Witteveen-type facility? Is that what you are recommending, something like that?

Ms. JUNZ. I do believe that if one could make the Witteveen facility more permanent, for example, that would be helpful. As you know, it is slated to run out in 1981 or 1982. It is one of the reasons also why the quota increase is so important.

Of course, you do not mobilize relatively as much OPEC funding through the quota increase, as you did through the Witteveen facility. Therefore, extending it is one of the avenues that should be explored.

Mr. CLEVELAND. To comment on your question, it is a very important one. From the standpoint of an OPEC country which has built up a surplus, or which has a current surplus to invest, the risk and return characteristics of any claim that it could acquire directly on an LDC are very unattractive. It would have to demand a very high rate of interest, a rate of interest which would be perhaps double what a bank would charge, or perhaps triple what a bank would charge. This is the reason that recycling has taken the form it has—that is, very heavily through intermediaries, either directly, in the form of deposits to commercial banks, or more indirectly, by the acquisition of securities or properties by the OPEC countries in developed countries from which the funds may move back to OPEC countries through various intergovernmental forms of transfers.

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Why produce the oil if all you are going to get for it is paper of a very high risk character. So inevitably one is forced to the conclusion that recycling has to continue more or less in the present form, or that it is done through some sort of official oil facility, a multilateral oil facility in which some international institution, which really means a collection of strong governments, is willing to subsidize the risk which the OPEC countries would assume in acquiring a claim on the oil facility. The facility would then lend to the LDC's at a rate comparable to what they could get from a bank, or perhaps a lower rate.

So in financial and economic terms, what has happened is what will happen, because it is the normal response of private actions to the incentives and pressures of the marketplace. So that if there is to be any direct assistance or direct lending by OPEC countries to LDC's, it's got to be for political motives.

And I rather agree with what Mrs. Junz said. I wonder whether it is such a great idea to encourage bilateral and special relationships between OPEC members and LDC's. There is a great deal of that, of course, already so far as the Arab world is concerned.

I do not really see the interests of the United States or the Western Powers in it, so long at least as it appears that the market solution of the problem is working to the point that the OPEC countries are willing to increase oil production—or maintain production anyway—and acquire the familiar forms of financial assets that they have acquired.

Professor MURPHY. Mr. Chairman, if I might add just a word, I would only say that it seems to me that the variable which none of us seems to be willing to take into account in this discussion is the price of oil. Surely if oil-exporting countries, for example, are reluctant to take on risky claims in the developing countries, and if, let us say for a moment, that the banking community were also unwilling to take on such claims, surely the oil exporters have two then-remaining avenues of adjustment.

One is not to sell their oil, the suggestion, for example, that Mr. Cleveland referred to.

The other is to sell it with less of an economic rent built into it—that is to say, to be less greedy in terms of the price.

And I cannot help but think that the willingness of the international community always to insure that financing is available has indeed led us to the situation in which we find ourselves, a situation in which one price increase, when digested, leads to the next. Indeed, the oil exporters obviously are sellers who must find a market for their product. And price is a part of the process of finding that market.

Now, I must admit I believe the international banking community has served us well in the past and will serve us well in the future in the sense that it will accept a great deal of the intermediation which the oil-exporting countries request. Indeed, the oil exporters, you will recall, in 1974 were enormously eager to have very short-term deposits in their Eurobanking facilities—that is to say, they wanted liquid assets rather than long-term claims. And on the other hand, the borrowing countries, the oil-importing countries, wanted intermediate to longer term credits in order to pay for their oil.

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The banking community by and large dealt with this situation very well. The markets worked very well, as Mr. Cleveland, as a matter of fact, has pointed out in some writings. Namely, we had a change in long-term, relative to short-term, interest rates until the rising longer rates and the falling shorter rates persuaded both borrowers and the lenders to accommodate each other.

We shall have such accommodation again. And all I am saying is we do not need to look continuously for supplementary sources of finance, by and large, to bridge gaps which could appear in the market if prices were unable to change.

Chairman NEAL. Mr. Cavanaugh.

Mr. CAVANAUGH. Thank you, Mr. Chairman.

I would like to express my gratitude again to the chairman and the panel.

This is an excellent panel this morning.

Before I do get in, Mr. Chairman, I would like to ask unanimous consent to include some items in the record that are relevant to the hearings we are conducting.

Yesterday we discussed a news article from the Wall Street Journal of Monday, February 4, 1980, relative to the debt and borrowing condition in Brazil, written by Everett G. Martin. I would like unanimous consent to include the article in the record of these hearings.

And, in addition, I would like to include the editorial in the Washington Post of February 7, 1980, entitled "The Poor Countries' Oil Bills," which makes reference to a recent statement by Federal Reserve Governor Henry C. Wallich.

I also request unanimous consent to include the statement of Governor Wallich entitled "The Future Role of Commercial Banks," made in New York City on January 24, 1980.

Chairman NEAL. Without objection, so ordered.

[The article from the Wall Street Journal; the editorial from the Washington Post; and the statement of Federal Reserve Board Governor Wallich, all referred to above by Congressman Cavanaugh follow:]

[From the Wall Street Journal, Feb. 4, 1980]

BIG BORROWER: BRAZIL COUNTS ON BANKS TO LEND MORE BILLIONS AS TOUGH YEAR LOOMS—HIGH PRICE OF OIL IS HURTING LAND INTENT ON GROWTH; WILL FUNDS COME EASILY?—MIRACLE WORKER TRIES AGAIN

(By Everett G. Martin)

SAO PAULO, BRAZIL.—Celso Ming, an economics analyst here, ponders Brazil's outlook for 1980 and concludes, "We are facing the worst situation in 20 years." Businessman Luiz Suplicy Hafers believes that Mr. Ming is unduly optimistic. "This will be the toughest year in our history," he says.

Why such gloom? Run Brazil's problems through your pocket calculator and you'll see. Exports in 1980 could reach $20 billion at most. From that, subtract $11.5 billion to import oil at $30 a barrel. Then take away another $10 billion to import essentials like food, raw materials and machinery.

Finally, having already gone past zero, subtract $14 billion more to make payments due on foreign debt. At about $50 billion, Brazil's external debt is the largest in the Third World.

Government economists can think of only one solution to all this: Borrow another $15 billion from banks around the world. Will the bankers go along? In the Brazilian view, they have little choice. Mr. Ming says:

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"If I owe a million dollars, then I am lost, but if I owe $50 billion, the bankers are lost."

DOUBTS ARE VOICED

Others aren't so sure that the new loans will come easily. Bankers often mention Brazil and the Philippines as heavily indebted countries that may have trouble borrowing more. "The private supply of funds isn't going to grow," says Robert Slighton, chief international economist of Chase Manhattan Bank. "It may not fall much, but at the same time funding needs are going to grow significantly."

They will grow because Brazil's problems are increasingly shared by a host of Third World nations. Amid worsening world economic conditions, these nations desperately seek not only to survive but also to sustain economic growth to satisfy their people. High interest rates notwithstanding, they still consider borrowing the only way out.

As long as a country continues to grow rapidly, Mr. Slighton says, "rollovers of loans aren't necessarily bad for a bank, even though it isn't something you would prefer to do." But for this year at least, rapid growth isn't likely anywhere. "The outlook for the world economy in 1980," Mr. Slighton says, "can only be characterized as bleak."

If any big gap develops between what Brazil wants and what it gets from the bankers, international lending agencies can't be expected to make up all the difference. For one thing, these agencies now are focusing on countries poorer than Brazil. Also, if Brazil borrowed many billions from, say, the International Monetary Fund, the organization would soon run out of ready cash and it has more than a hundred other countries to worry about.

LAST RESORT

Anyway Brazil wouldn't turn to the IMF except as a last resort because IMF policy is to require economic policy change—usually unpleasant ones, such as budget slashes and tax increases—as a condition for granting large loans. The idea is to solve the problems necessitating the borrowing. Brazil wouldn't relish such strong medicine, especially since it feels, as Mr. Ming puts it, that it is "the victim of a world situation out of its control."

Mr. Ming notes that Brazil, like many other Third World countries, is victimized by the price increases both of the oil-exporting nations and of the industrialized countries that are compensating for their own higher fuel bills. Brazil is even hurt, he says, by actions that seem far removed such as the Federal Reserve Board's Oct. 6 credit-tightening moves that raised U.S. interest rates. That cost Brazil $1 billion more in interest payments because up to three-quarters of its debt is in Eurodollars—dollars on deposit outside the U.S.—and interest rates on Eurodollar loans move up and down in line with domestic U.S. interest rates because of supply-and-demand factors.

Brazil isn't even considering going hat-in-hand to its creditors—mainly U.S. European and Japanese bankers—to ask for relief on its debt payments. Karlos Rischbieter, who recently resigned as finance minister, of Brazil's military-run government, argues that all oil-importing Third World countries are in debt "to such an absurd degree that it is starting to create banking problems; if oil reaches $35 a barrel, it isn't Brazil that will take the initiative to renegotiate the debt—the whole world will have to sit down" and tackle the problems.

A SHOWDOWN SOON

With service charges on foreign debt chewing up more than half of many countries' export earnings, analyst Ming believes that such a showdown is coming soon. "It's a world-wide situation, and it is so bad that the whole world will have to adjust," he says. "Only then can Brazil adjust to the new situation."

Meanwhile, President Joao Baptista Figueiredo has tightened Brazil's fiscal policies—indicating, however, that there isn't much more that Brazil can do. "Our problem," he said in a December speech, "is creating conditions to sustain the flow of resources (loans) that will finance our deficit."

A representative, of a U.S. bank here complains that President Figueiredo "talked as if continuing to borrow were only a Brazilian decision, but their loans are so big that the big banks can't roll them over alone." This source says that many major U.S. banks are already approaching their legal limit on loans to Brazil—no more than 10 percent of a bank's capital may be lent to any one borrower.

"We have to get the participation of second-tier banks that aren't already committed to Brazil," he says, "and there isn't any reason why they must participate."

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Japan has already warned its bankers against extending more credit to financially strapped Third World countries. But European bankers told Gazeta Mercantil, Brazil's most influential business daily, that Brazil can probably get the $15 billion it needs if it is willing to accept shorter payment terms and higher interest rates.

Since the 1960's Brazil has made up for a lack of local capital by taking in foreign funds, in the form of capital investment and loans. The economic planners basically used two methods to keep the debt load from becoming a burden: They carefully programmed the repayments, and they pushed dollar-producing exports of manufactured goods by giving subsidies and tax breaks to local companies.

Through the early 1970's, this program produced year after year of rapid economic growth that came to be called "the Brazilian miracle." The quadrupling of world oil prices brought an end to the miracle in 1974.

Brazil, which has to import 80 percent of its oil needs, saw its oil-import bill climb from less than $2 billion in 1973 to nearly $7 billion last year. The effects were masked at first by the record prices that Brazil was getting for its exports of sugar, soybeans and coffee. The planners were lulled, too, by the ease with which they could borrow the so-called petrodollars that the newly affluent oil-exporting countries were recycling through the major banks. The government of former President Ernesto Geisel, says the economist of a U.S. bank's Rio de Janeiro branch, "made the monumental error of thinking that Brazil was going to be an island of tranquility in a sea of turmoil."

GROWTH STILL STRESSED

Pressured by a population growing at nearly 3 percent a year (to 124 million last year), which creates a need for 1.2 million new jobs a year, policy remained locked on growth. No one was particularly concerned when the debt reached $35 billion by 1978. Businessmen—who owe about 40 percent of Brazil's foreign debt—were even encouraged by tax incentives to borrow as many Euro-dollars as they could.

"They (the government) focused on big projects in all areas when they should have aimed at priority in energy substitution and building railroads to replace trucks," says Claudio Haddad, economist for a Rio investment firm. "They simply wouldn't recognize the need or they thought we could do everything at once."

The hard facts finally made themselves clear after President Figueiredo took office last year. At the outset of his administration, his economists said they would cut inflation back from 40 percent. They would hold the increase in the money supply to 30 percent; it swelled by more than 60 percent. They would reduce foreign borrowing; they had to increase it.

Rising oil prices and weather-caused short-falls in critical crops helped trip the planners up, but it was also apparent that no one was in control of the vast federal structure.

Huge government companies in banking, oil, power, nuclear energy and steel operate practically without supervision and subject to none of the restraints on importing and borrowing that limit private firms.

The budget defies analysis and is shot through with hidden deficits. They are caused mainly by a ponderous bureaucracy that administers a bewildering maze of permits and subsidies to business. The main subsidy is low-cost loans.

Originally intended to stimulate investment in government-targeted areas, the system has become the principal engine of inflation: 80 percent of all domestic credit is granted with some kind of subsidized interest rate far below regular bank rates, and the government creates money to make the loans.

After seeing his 1979 economic policy fail, President Figueiredo ousted the head of his economic team in August and replaced him with Antonio Delfim Netto. It was Mr. Delfim, who, as finance minster in the early 1970's, got credit for engineering the late Brazilian miracle. He also created the tangled web of costly subsidies that he now is supposed to untangle.

"Delfim is a power politician," says a long-time friend. "He will cut guys who get in the way, and he's willing to take chances." In characteristic style, Mr. Delfim has promised to reduce bureaucracy, put controls on the state companies, end the subsidies, cut inflation (to 52 percent this year) and expand imports while he keeps the economy growing without a recession.

These measures, first outlined over nation-wide television by President Figueiredo in December, are being phased in over at least two years. But also wrapped up in the bright-sounding package was an immediate 30 percent devaluation of the cruzeiro. As a result, the cruzeiro was worth 2.4 cents at the end of 1979, compared with 4.9 cents a year earlier.

The announced aims of devaluation are to lower the price of Brazil's manufactured exports so that they can undersell foreign competitors without getting government subsidies, and to slow imports by making them more expensive in local

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currency. But the immediate impact was to vastly increase the debt of the hundreds of companies with Eurodollar loans; suddenly it took many more cruzeiros to obtain the dollars to make repayments with.

"We were seduced by the government into taking the loans, and now we are betrayed," charges the head of the industry association of the southern city of Porto Alegre. Mr. Delfim promises that the government will aid companies seriously hurt by the devaluation.

Economists like Mr. Haddad don't think Mr. Delfim has enough up his sleeve to work any kind of miracle this year. Mr. Haddad forecasts another round of inflation followed by recession. He expects unemployment to rise as firms cut back on manpower to help absorb the devaluation blow and the economy fails to produce enough new jobs to keep up with unchecked population growth.

[From the Washington Post, Feb. 7, 1980]

The Poor Countries' Oil Bills

In Turkey, buildings are going unheated this winter and industrial production is rapidly declining. Inflation and street violence are rising together, a double index of distress. The country is suffering acutely from lack of oil and the foreign exchange to buy it. As Americans grumble about the rising price of fuel, they might keep in mind that the effects here are very mild compared with those in the poor countries.

There the cost of oil is jeopardizing the whole crucial process of economic development and, with it, the stability of society. But some of Turkey's close neighbors are countries whose stability is, conversely, threatened by the sudden rush of new wealth that the oil is bringing them. To reconcile these extremes somehow, and to keep the oil flowing without disaster, is a test of skill and statemanship that now urgently confronts the people who comprise the world's financial system. They haven't much time.

In the first oil crisis six years ago, there was immense anxiety over the process known as recycling. That meant lending oil revenues back to the buyers to enable them to buy more. As it worked out, recycling went surprisingly smoothly. The OPEC countries put their surpluses in American and European banks that then passed them on to borrowers in the developing countries. Shortly, the OPEC surpluses began to decline, as the oil-exporting countries found ways to spend their new wealth faster than anyone had thought possible. After the first jolt, the poor countries' economies were soon growing nearly as fast as ever. As a broad generalization, you could say that the rich nations carried the burden of more expensive oil in the form of lower growth rates, while the poor ones carried it in the form of mounting debt.

But the success of that earlier experiment in recycling seems to have made the world overconfident and inattentive. The present strains are more ominous than those of 1974, and the last recycling operation probably cannot be repeated.

Many of the banks have already loaned to the developing countries as much as they consider safe. The Federal Reserve Board has begun to remind the American banks, tactfully but publicly, about the dangers of overexposure in the Third World. As for the OPEC governments, they are not likely to accelerate spending again as they did after 1974. Most of them consider Iran a warning of the consequences of spending too much too fast.

This time the developing countries will have to divert money from investment to oil payments; that means less growth. Turkey has already devalued drastically, as have Brazil and Korea. That can help, but it's hardly enough. If the OPEC governments do not rapidly begin lending directly, there can be no solustion that does not impose severe deterioration of living standards on Turkey and other vulnerable countries throughout Asia, Latin America and Africa. Henry C. Wallich of the Federal Reserve Board recently made the interesting suggestion that, instead of lending to the developing world on their own credit, the multinational banks might arrange direct loans by the oil-exporting countries. That would leave the risk with the sellers of oil, not with banks that are already carrying enough of it. OPEC created these risks and, as Mr. Wallich observed, it seems incumbent on OPEC to share them.

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THE FUTURE ROLE OF THE COMMERCIAL BANKS

Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

at the conference on

New Approaches and Techniques for Managing Country Risk

New York City

January 24, 1980

I am happy to have this opportunity to address the seminar on managing country risk. The topic once more has become a timely one. Two-and-a-half years ago, some of us participated in a symposium on "financing and risk in developing countries," the organization of which, like that of the present seminar, also was in the capable hands of Steve Goodman.

Some of the problems that we have to discuss today are quite reminiscent of those of mid-1977. Curiously, however, this is in good part not because the problems have persisted, but because, after at least in some degree having gone away, they have now come back with a vengeance. By that I mean, of course, that in 1977 we were still concerned with the problems created by the oil price rises of 1973-74. One pressing issue was the allocation of OPEC-induced current account deficits. Should the deficits end up in the LDCs where the capital inflow might be most needed, or in the industrial countries that could best finance them? In the period following, the surplus of the OPEC nations largely vanished, a massive deficit appeared in the United States and disappeared again, and the developing countries continued to grow, thanks in large part to continued heavy bank borrowing. Now the OPEC surplus is back bigger

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than ever. One factor, however I believe, has changed significantly: the ability of the banking system to handle the ensuing deficits on the terms and conditions to which the market had become accustomed in the meantime.

During the last two years or so until very recently, the market has become very much a borrower's market. Minimal spreads, a severely compressed differential among spreads for different borrowers, longer maturities, and the large size of loans all document this condition. There are several reasons why this situation is likely to change. They lie both on the side of the borrowers and of the banks. On the side of the borrowing LDCs there is, first, the higher burden of oil imports. This comes on top of an already visible increase in burden of debt relative to the ability to carry it. At the new level of oil prices, the oil import bill will absorb, on average, one-third of the export receipts of oil-importing LDCs in contrast to an earlier one-sixth. This leaves less available for debt service as well as for payment of other imports. It changes, in other words, the meaning of a given debt service ratio.

There is, second, the previous rise in the burden of debt. This rise is by no means spectacular, but neither can it continue to be overlooked. Aggregate foreign debts of non-oil LDCs approximately tripled in the five years from 1973 to 1978 and rose perhaps an additional 25 percent in 1979. These rough numbers ignore unrecorded short-term debt, which adds to the burden, as well as the growth of foreign exchange reserves, which reduces it. But the proportionate increase in the debt would hardly be much altered if these variables, which probably rose on roughly the same scale during the period, were taken more fully into account. Since oil-importing developing countries experienced substantial inflation in their

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foreign trade prices -- perhaps 70 percent in export unit values and 80 percent in import unit values -- the increase in debt burden in real terms is a good deal less. What is more, the real interest rate paid by the average borrower was probably negative. LIBOR (London Inter-Bank Offer Rate) for 90-day dollar obligations averaged 7.9 percent over the years 1973-78, as against an average price increase of about 11.0 percent. Only in 1979, did LIBOR at 12.0 percent exceed a rise in the price of primary products (excluding oil) of 10.4 percentage points. Of course, the experience of some countries is bound to have differed from these averages. Because of these differences, the real interest rate, defined as the nominal interest rate minus the expected rate of inflation over the life of a loan, in an international context, is less meaningful than in a domestic context.

But despite negative real interest rates, the familiar debt ratios have tended to increase. From 1973 to 1978, the average ratio of gross debt to GNP rose from 17 to 23 percent, that of net debt (after deducting reserves) to GNP from 11 to 17 percent, and debt service requirements to total exports rose from 14 to 17 percent, for a group of 99 non-oil LDCs. Recognizing the wide variance of these ratios among countries, as well as great differences among countries in their ability to handle debt, and keeping in mind also the limitations of any form of ratio analysis, these data nevertheless signify some deterioration up to the end of 1978.

It is at this point in the story that the rising price of oil threatens to raise the deficit of non-oil LDCs from $25 billion (including official transfers) in 1978 to perhaps $50 billion (including official transfers) in 1980. To me, this suggests a different response to the problem of deficits than was widely adopted in 1973-74. If at that time the principle was to finance rather than adjust, today it may need to be reversed. Many developing countries will be well advised to stress balance-of-payments adjustment in preference to additional

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financing. Some adjustments are already underway, as witness the devaluations in Brazil, Chile, and Korea. Such adjustments should be easier to make in today's environment than in 1974-75 because world economic activity is better maintained presently than it was then.

My main concern here today, however, is with the lenders rather than with the borrowers. How much of the borrowing of the developing countries will the bank be able and willing to handle? Outstanding claims on non-oil LDCs of all banks reporting to the BIS rose at an average rate of 23 percent per year from December 1975 through June 1979. Such a rate of growth exceeds, of course, the rate of overall credit expansion that can be sustained by any banking system not in the grip of galloping inflation.

For instance, total bank credit in the United States, over the same 3-1/2 years, grew at an average annual rate of 10.9 percent. Shifts in the composition of assets, implying faster growth of some and slower growth of other components are, of course, always going on and are indicative of the flexibility of the banking system; but as particular components, such as LDC loans, come to constitute an increasing share of the total, their growth necessarily must slow down. Thus, the rapid growth of LDC lending had some of the characteristics of the filling of a vacuum. Lenders, borrowers, and regulators all have an interest in seeing that this vacuum is not converted into a compression chamber. That is implicit in the dynamics of any growth pattern. In the case of bank lending to non-oil LDCs, it is the consequence also of particular limitations encountered by banks in terms of their risk exposure with respect to particular borrowers and their overall ratio of capital to assets.

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foreign banks make dollar loans, the volume of their lending is also influenced by U.S. monetary policies.

Capital ratios and LDC risk exposure of American banks may also be assumed to have played a role in their decision to slow LDC lending. The ratio of equity capital to total assets of the nine U.S. banks with the most international business, after improving from a low of 3.7 percent in 1974 to 4.3 percent in 1976, once more deteriorated to 3.9 percent by mid-1979. Bank earnings have been inadequate to keep bank capital growing in line with the inflation-driven volume of bank assets. Assuming a dividend payout of one-third, banks would have had to earn 18 percent on assets in order to keep up with the approximate 12 percent average growth of bank assets during the years 1976-78 if they are to rely almost exclusively on retentions. But new stock issues, which could relieve this situation, have been very difficult to make, given the very low price/earnings ratios characteristic of leading American banks. These reflect, in turn, the market's realization that the real value of bank capital and, therefore, bank earnings is reduced by a factor of about 3/4 of the going rate of inflation, making allowance for nonmonetary assets equal to only about 1/4 of capital that could protect that capital against inflation.

Foreign banks in many instances are less constrained by capital than are American banks and thus can accept lower spreads. In some countries, lower capital ratios than in the United States are characteristic of most banks. In some countries also, foreign banks receive better protection against inflation by a greater ownership of nonmonetary assets such as participations and real estate. Maintenance of capital ratios has been easier for such banks because a better inflation-protection

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of earnings has permitted stock issues. In some countries, finally, banks are owned and backed by their government.

But it is probably in terms of risk exposure with respect to particular borrowing countries that U.S. banks have encountered some of their most obvious limitations. The in-house country limits set by banks, arrived at normally on the basis of careful country risk analysis, are, of course, fairly flexible. But banks nevertheless have to watch carefully their concentration ratios, which are monitored by means of the Federal Reserve - FDIC - Comptroller of the Currency's country risk evaluation system. These focus on the percentage of capital exposed to risk in each particular country. For most industrial countries, regulatory considerations are not particularly inhibiting. Exposures over 25 percent of capital funds in any such country are "listed" in examination reports, but usually no comment on such exposures is made. For most G-10 countries, lending by many U.S. banks exceeds 25 percent of capital.

For many LDCs, however, exposures even to most of the financially stronger borrowers, would be "listed" if the level exceeded 10 percent of capital funds, and exposures in excess of 15 percent receive special comment in the examination reports. The largest LDC borrowers would be subject to such comment in a number of U.S. banks. Comment does not necessarily imply that there is an inherent credit weakness, but is made to alert management to exposure levels. While banks are not prevented in any way from making loans to LDCs in excess of the comment level, a decision to raise exposure significantly is properly one to be taken in full awareness of the facts by senior management. Qualitative differences in exposure, as inherent for instance in the difference between short-term, trade-related credits and long-term, syndicated loans, are important.

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If banks with exposures above the comment level wished to avoid an increase in these exposures, their lending could increase only in proportion to the growth of their capital, i.e., roughly on the order of 10 percent of present lending levels. For the group of banks having much the largest part of the loans to Brazil and Mexico, for instance, such an internal decision would mean an increase in loans to Brazil of about $1.5 billion over the next year.

Broader participation in LDC lending by larger numbers of banks would help to make more flexible the supply of bank loans for LDCs. The reduction in the share of U.S. banks in this lending, accompanied by strong expansion, at least until recently, by banks of many other countries, represents one such form of diversification. However, within the confines of U.S. banks, there has been no broadening of participation in foreign lending generally. On the contrary, the share of the nine largest money center banks in loans to foreign banks and nonbanks remained virtually unchanged at 68.2 percent in December 1977 and 68.6 percent in June 1979. The share of these banks in loans to LDCs stood at 63.9 percent and 64.5 percent during the same period. Meanwhile, 15 regional banks reduced their share in total loans to foreigners from 17.4 percent to 16.5 percent while that in loans to LDCs remained constant at 18.7 percent. Other banks, accounting for relatively small amounts, reduced their share of lending to LDCs.

So far, the slower LDC lending by U.S. banks seems to have been compensated by more aggressive lending on the part of the banks of other countries. If the slower expansion of LDC lending by U.S. banks has continued since mid-1979, there would nevertheless be room in the

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portfolios of banks in other countries or the obligations of creditworthy LDCs. Most of the large non-U.S. banks still appear to have a lower ratio of foreign assets to total assets than do large U.S. banks. They should be able therefore to accommodate a relative increase in foreign lending. It seems likely though, that lenders will have to be offered better terms and that borrowers may have to look toward adjustment rather than financing to an increasing degree. In this regard, it might be noted that Japanese banks have recently also curtailed their foreign lending.

For the longer run one must ask whether the world's banking system can meet increasing demands by the LDCs even if these demands reflect genuine investment financing rather than the financing of consumption-oriented oil imports. The banks have, in a sense, pioneered LDC lending. Their lending practices have many desirable attributes that would make a continued strong role of the banks in LDC financing constructive.

There is no shortage of funds in world financial markets, thanks not only to OPEC surpluses, but to the demonstrated ability of the Euromarkets to draw funds from all over the world by offering attractive interest rates. Nor is there a shorage of high quality assets in which OPEC and other surplus countries, if there are any, could invest these surpluses. The difficulty resides in recycling these funds toward the deficit countries, where they would be at some risk. It seems incumbent on OPEC to assume some of the risks inherent in the process.

New forms of bank pioneering may be needed. For instance, banks might take on the role of arrangers or brokers of loans. The risk of

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such loans would fall on the ultimate lender, instead of a bank substituting its own credit for that of the borrower. Such activities would not strain the banks' capital ratios.

The IMF may have to play a larger role. Banks have been partly at fault in creating a situation in which the IMF has been brought into the financing picture only after the banks have vanished from the scene as willing suppliers of a weakening borrower's credit. Banks have seemed to act as if countries were either creditworthy, in which case they got all the money they wanted, or they were not, in which case no further credit was offered. Some form of cooperation with the IMF, which would strengthen the borrower's performance through IMF conditionality, would be preferable to such an all or nothing approach. As we look toward the longer-run future, more new forms of LDC financing, will probably need to be developed.

Mr. CAVANAUGH. Thank you. Mr. Chairman.

Professor Murphy, I think you make an interesting point here. What you are saying is that the system that we have concocted, as it relates to oil prices—and it seems to dovetail with the commentary of Mr. Cleveland—that by absolving the oil producers and the surplus nations of the economic risk, as long as they are able to pass on the consequences, the economic consequences or the risk consequences, as it were, it facilitates and encourages irresponsible and excessive oil pricing.

I think that is a very devastating commentary.

Mr. Cleveland, do you find any validity to that at all?

Mr. CLEVELAND. Well, I think from one standpoint you can say that it is correct. But I think, as in all affairs in the real world, one has to ask about alternatives. Does the point lead to the conclusion that it would have been better to prohibit all financing of all deficits other than the direct financing by OPEC to the LDC's?

Mr. CAVANAUGH. I missed the one word.

Mr. CLEVELAND. Would your comment lead to the conclusion that it would have been a better policy to interfere with or prevent financing of LDC deficits due to the oil price increase?

Mr. CAVANAUGH. I don't think that that is——

Mr. CLEVELAND. Don't you inevitably come to that point?

Mr. CAVANAUGH. No. I think, you know, the whole discussion here is clearly in dealing with the economic realities that confront us. The economic reality is how do you most efficiently, most effectively, most equitably transfer the surpluses that have been accumulated? How do you recycle those——

Mr. CLEVELAND. But they have been transferred.

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Mr. CAVANAUGH [continuing]. In the soundest economic terms.

Mr. CLEVELAND. They have been transferred, and the inevitable effect of the transferring or financing is to make it easier for the sellers of oil to maintain a higher price.

Now, there is no denying the economics of that.

Mr. CAVANAUGH. OK. But then let us shade the question here—I mean, let us put it in appropriate perspective. We are not dealing in extremes. What we are saying, are there alternative policy and economic structural conditions that we can create, accommodate the needs for recycling, but minimize the stimulus for irresponsible pricing?

And you are saying we do not have any alternative. What I hear you saying is what we have done has worked in terms of recycling, and there's just nothing you can do in terms of the irresponsible pricing consequences.

Mr. CLEVELAND. I think that is basically my position. It seems to me that the question of pricing is a question of high politics. If one wishes to influence the decisions of the OPEC countries on price, it means that you have got to find ways of influencing their basic political interests and making a trade with them, in effect, for a lower price in return for other benefits, perhaps of a noneconomic character, which they wish.

That seems to me to be the guts of the pricing issue. By interfering with or reducing or making more complicated the process of recycling, their surpluses—their financial surpluses—you might conceivably have some effect on the price, a marginal effect, although I doubt even that, because they can reduce production and hold the price in response to that kind of thing.

You are really going to throw the baby out with the bath. You are going to cause a lot of genuine economic disruption and hardship. You may very well end up with lower production and the same price level.

Mr. CAVANAUGH. The most recent rendition of this suggestion comes from the speech of Governor Wallich which I just alluded to and included in the record.

Are you familiar with that?

Mr. CLEVELAND. I am not. No.

Mr. CAVANAUGH. Here is Governor Wallich's expression of it in New York. On January 24, he says:

> New forms of bank pioneering may be needed. For instance, banks might take on the role of arrangers or brokers of loans. The risk of such loans would fall on the ultimate lender instead of the bank substituting its own credit for that of the borrower. Such activities would not strain the banks capital ratios. The IMF may have to play a larger role.
>
> Banks have been partly at fault in creating a situation in which the IMF has been brought into the financing picture only after the banks have vanished from the scene as willing suppliers of a weakening borrower's credit. Banks have seemed to act as if countries were either creditworthy, in which case they got all the money they wanted, or they were not, in which case no further credit was offered.

Mr. CLEVELAND. I certainly have no objection in principle to the notion that it would be desirable to market securities of LDC's in the financial markets and that banks might have some role to play in that, other than the actual purchase of the securities themselves. But I wonder whether such securities could be very attractive. That is the question.

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Mr. CAVANAUGH. Well, it leads me then to—you know, in your commentary earlier—the troubling question of the level of risk. The risk of lending to LDC's so unattractive to OPEC, how can the risk be justified by a bank such as Citibank?

Mr. CLEVELAND. That brings the basic theory of banking or financial intermediation. Banks can accept these risks because they have an enormous portfolio of assets of widely varying risk characteristics and return characteristics. They can find a corner, so to speak, of their portfolio for this type of loan, whereas a lender like an OPEC country which could only make this one kind of loan, would not be able to accept that risk, except at a very much higher interest rate.

That is the reason that banks play such a large part in recycling.

Mr. CAVANAUGH. What you are saying is that the loans that Citibank has extended to high risk LDC's, the actual risk exposure there is not reflected in the charge and the interest rate extended to the LDC but is spread among the rest of Citibank's borrowers.

Mr. CLEVELAND. The risk that matters to the bank is the risk of its entire portfolio.

Mr. CAVANAUGH. Right.

Mr. CLEVELAND. Not all LDC loans are going to go bad. Maybe none of them are going to go bad. As long as the bank gets a rate of return which seems adequate to it for that asset, for that loan, and as long as the bank's overall——

Mr. CAVANAUGH. That risk?

Mr. CLEVELAND. Yes, that risk. And as long as the bank's overall portfolio is so structured that only a small part could go bad at the same time, the bank can make loans whose inherent risk is higher than some of its other loans. This is the principle of diversification, and as you know it is fundamental to all banking. It depends partly on the law of large numbers. Because it spreads its overall risk over a large, diversified portfolio, a bank can and should take on some loans that may be riskier than others. Adding such loans may actually reduce the overall porfolio risk if they make for greater diversification.

Mr. CAVANAUGH. But the problem of an OPEC surplus nation extending direct loans to a high risk LDC would be that it has not a broad enough portfolio to sustain and justify the actual risks that would be inherent in that more narrow portfolio, confined strictly to oil-importing-deficit LDC's, and to actually price the real risk inherent there would be prohibitive.

Mr. CLEVELAND. Yes, if it were a big part of its portfolio.

Mr. CAVANAUGH. So Citibank is subsidizing its loans to LDC's on the basis of the rest of the portfolio that it's carrying?

Mr. CLEVELAND. No, it is not subsidizing, because on average——

Mr. CAVANAUGH. It is not pricing them on the same basis that an OPEC country would have to, assuming the real risk inherent in those loans.

Mr. CLEVELAND. You see, the risk in a loan is partly inherent in the loan and is partly inherent in the loan's relationship to the total portfolio. What the bank is concerned about, and any lender is concerned about, is the overall risk characteristics of the portfolio.

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Mr. CAVANAUGH. But your LDC risks are higher than others. Right?

Mr. CLEVELAND. Not than all loans in the portfolio, no. There are many smaller loans——

Mr. CAVANAUGH. But they are not priced higher than others.

Mr. CLEVELAND. They are priced in accordance with the bank's judgment of their risk in the context of the portfolio.

Professor DUNN. May I make a couple comments on that issue?

I think Mr. Cleveland's remarks were correct. Very early in the game when OPEC did not have much money, the banks made large loan to the non-oil-developing countries. OPEC has now accumulated a current accounts surplus well in excess of $200 billion since 1974. My rough estimate is about $230 billion. The vast majority of that is in four countries and probably half of it in Saudi Arabia. Saudi Arabia's accumulated current account surplus is probably close to $100 billion. That is a pretty big bank, and the Saudis ought to be able to find a little corner in their portfolio for loans to non-oil-developing countries. I am not thinking of little bilateral deals. What I had in mind was investment banking packages put together——

Mr. CAVANAUGH. Something as described by Governor Wallich.

Professor DUNN. Where shares would be placed with various OPEC countries. The commercial banks could arrange such packages outside the United States. I believe within the United States they are prohibited from involving themselves in this kind of activity. But outside the United States you can do it.

I think more of this could be done, and the OPEC countries have big enough portfolios to take such loans.

Mr. CAVANAUGH. Do you think it would be desirable?

Professor DUNN. Yes. I think it might be encouraged, perhaps diplomatically by the United States, and that the investment banking firms ought to do it or the commercial banks operating outside our borders. I hope this will happen.

I hope the market will produce this result, because I think some of the big commercial banks are going to have to pull back a little bit.

Mr. CAVANAUGH. Why do you say that?

Professor DUNN. Because I think, as was indicated in the original testimony, that the large commercial banks are fully extended or close to it in terms of prudent proportions of their capital or their total deposits in some of the developing countries. A continuation of new lending at the rates of recent years is not likely. The big banks cannot prudently continue to lend $30 billion a year in new funds, plus refinancing, to non-oil-developing countries.

Mr. CAVANAUGH. Mr. Cleveland, do you think they are on the verge of imprudence?

Mr. CLEVELAND. No, I do not think so. I wouldn't say so, and I do not think that the demand of the LDC's for balance-of-payments financing will continue in the order of $30 billion indefinitely. I think just as happened the last time after the first oil shock, there was a tendency for the deficits to shrink. If you make allowance for inflation, I would suspect that the demands of the LDC's, say beyond 1981, will shrink considerably.

Chairman NEAL. Ms. Junz has a comment.

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Ms. JUNZ. Mr. Chairman, I would like to associate myself with the remarks Professor Dunn just made. It was something of that nature that I had in mind in the testimony I submitted.

However, I would like to make an additional point. I think it is entire erroneous to say that the financing of LDC current account deficits is what is keeping the price of oil at current levels. We ought to remember that net imports of all non-OPEC LDC's are about 2¾ million barrels of oil a day compared with OPEC exports of 28¼ million barrels a day.

It is our own addiction to petroleum consumption that is keeping the price of oil up. Unfortunately, in a way for the world, the big industrial countries have no problem in financing this addiction. In this case, I think we ought not to blame the pusher but ourselves for our addiction to excessive consumption.

Chairman NEAL. Yes, sir.

Professor MURPHY. Mr. Chairman, if I may add one more word. I hope you have sensed that my own view is not that the international banking community should not be used by both the oil exporter and the oil importing countries and that it is the role of intermediation and pooling of risk is an important economic function.

My comment, I think, is directed at the mentality that all of us have—that when we fear there may be an inadequacy of financing under any contingency, we hasten to fill the gap and assure that there is still more. That mentality, I believe, has driven us into the kind of inflationary process in which we now find ourselves.

Chairman NEAL. I agree with both of the last comments very strongly.

Do you have any other questions?

Mr. CAVANAUGH. I did have some other concerns, Mr. Chairman.

Chairman NEAL. If the gentleman will yield, let me ask another one while you are looking at that.

One of the problems that we face with this legislation, probably the most difficult problem, is the question concerning conditionality. I just want to thank you all for your clear statements on this question.

I am especially troubled by the fact that a number of people who have deep concerns for the poor are simply not following—attempting to gain a total perspective on what is available in the real world and what is not available and what the IMF is and what it is not and are blaming the IMF for conditions that have been caused by governments, which the IMF is trying to solve in the only way that it can move to solve them.

I should not say the only way. There certainly could be some minor modifications in terms of its loans and conditions and so on, but I think it is critically important that I find a way to do all I can to convince the critics of the Fund that they are simply criticizing their own thing—that they need to go more to the heart of the problem.

So I just want to thank you for your clear statements on this.

Professor DUNN. May I make one small comment on that?

If the United States is unhappy with the social and economic impacts on the poor of conditionality requirements, I would suggest we increase our appropriations for foreign aid, and that upon occa-

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sion when a conditionality program looks like its going to squeeze food in the barrios of some South American cities, that Public Law 480 grain or something like it be provided as a bridge to feed these people while the program works.

This would not interfere with the Fund's program. What the Fund is interested in controlling is the rate of growth of the money supply, and that means government deficits. If we feel strongly about this, the Congress can appropriate the money to buy the grain. We seem to have some grain looking for a home at the moment, and we could help.

Chairman NEAL. I quite agree, and I recommended Monday, I guess it was, that the Fund see if it can't find ways of working in closer cooperation with the World Bank in some of these most difficult cases to do precisely what you are talking about. We could broaden that to Public Law 480 assets and other considerations.

But we do need to keep the Fund itself true to its mission that private capital won't be generated if the Fund eases its conditions to the point that they don't make any sense, that they are not in fact an economic stabilization program.

Mr. Cavanaugh, thank you.

Mr. CAVANAUGH. I feel the chairman was talking about me.

Chairman NEAL. No, not only you. I say to may friend——

Mr. CAVANAUGH. Those critics of the IMF.

Chairman NEAL. You have been most critical of the Banks' role. I think clearly——

Mr. CAVANAUGH. I try to be critical of everyone. [Laughter.]

Let me say, it is a little distressing, though, to have this entire panel—I think with the exception of Professor Murphy—here we are discussing the condition, the economic conditions of the world. And to have none of you refer in you statements to the fact that there are poor people, that there are people in fact at all who will live their daily lives according to the consequences of the policies that we devise in this warm, well-lighted, and antiseptic environment that we live in and to delude ourselves that their lives are not equations in the economic fabric of the world.

And it seems to me so irrational that I have never been able to relate to it since I have been here—that we can talk about LDC's and all the other jargon that we accumulate here and not understand that the ultimate purpose of that is to create a world order in which human beings live. And to simply juggle current account surpluses and deficits—certainly we have to talk about those things—certainly macroeconomics or the kind of policy—but when you do it in a mind set that eventually overcomes the reality of the world in which it is supposed to relate, you are not devising sound economics. You are devising naive and I think extremely shortsighted economics.

But it is a thing that we contend with. I have some other more substantive questions to go into.

Chairman NEAL. Will the gentleman yield? I would like to say first of all that I don't know of anyone who is suggesting what you suggested that we are. The whole purpose of these institutions and hearings is to try to do things that will provide stability and peace and prosperity and demonstrate a concern for people. It certainly

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makes much more sense to talk about the details of these plans than it does about individual people, doesn't it?

Obviously the purpose of all of this is to help people.

Mr. CAVANAUGH. I select a portion here of the testimony as expository:

> Thus the freeing of the economy of restrictions earlier imposed to suppress the symptoms of the consequences of economic mismanagement which involves adjustments in the price mechanism, including the exchange rate and the control of credit expansion and in particular to the public sector, constitute basic elements of any stabilization effort. Although this approach has been variously criticized, recent economic research tends to support these orientations.

Now that is a correct rendition of a number of economic factors. But it is oblivious to the fact that when you are talking about price mechanism, exchange rate, control of credit expansion, and particular spending of the public sector, what you are talking about in human terms is how much income the people of a given nation are going to have to sustain their basic livelihood, how much productive economic activity, jobs, that they are going to have, which means in human terms, dignity, self-respect, social orientation, and how much basic ability they are going to have to survive and function.

And there is no mention of unemployment which relates to the specific conditions that human beings will suffer as the result of price mechanisms, exchange rates, controls, and flows of credit. They are real. There as real economic factors to be considered—those of us who are saying to the IMF—I know of no one who has testified here, no one who has ever advocated in the Congress that there not be conditions attached to IMF extensions of credit in cases where adjustments are necessary.

I have never heard that. And you begin your testimony with those extremes of people who say that there should be no conditions. Everybody testified that these people who are arguing against conditionality—that is a straw man and an extremity that obscures the reality of what we are talking about. It says that sound economics requires that when we approach readjustment, that we approach it in the totality of the economic, political, social, human reality that exists in that particular national setting.

And anything short of that is inadequate and short-sighted policy and doomed to destruction, doomed to failure.

Ms. JUNZ. Mr. Chairman, since it is my testimony that is being quoted, let me please set the record straight.

Mr. CAVANAUGH. It could have been anyone's.

Ms. JUNZ. First, the sentence after the passage you quoted reads:

> This does not mean that corrective measures should not be fashioned in such a way as to mitigate hardships, particularly for those least able to bear them.

But much more important—and this is what you, Mr. Chairman, have already indicated—stabilization programs are not aid programs. I think they need to go hand in hand with aid. The IMF in prescribing the macroeconomic conditions needed to get back to a growth path that will create more production, which in turn will create greater growth and probably less inequity, leaves the freedom to choose how to do that to the government in question.

If the government in question chooses not to cut military expenditures but cuts food subsidies, you cannot blame the IMF for that.

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Mr. CAVANAUGH. Wait a minute. Citibank is making loans to the country to purchase military expenditures so that the country can go and purchase sophisticated military equipment from Lockheed. The condition arrives at a condition where it can no longer meet all of its financial needs.

So the IMF comes in and says, you must impose conditions. The country begins to impose conditions that reduce the import of basic foods and subsidies, continues to procure armaments and to secure loans from a major U.S. bank in order to finance those armaments.

And you are telling me that it is prudent, sound, economic discipline and planning for the IMF to extend credits that perpetuate that system and say, we can't make a judgment on the economic soundness of the internal policies that this country is going to create.

Ms. JUNZ. The IMF, by the guidelines that have been imposed on it by its membership, cannot tell a sovereign country in detail what it should do.

Would you like the IMF to come in here and tell the Congress not only that it should cut public expenditures, but also set the priorities. In effect, tell you that the structuring of your authorizations and appropriations are wrong, and that they should be reordered according to social priorities as conceived by the IMF?

Would you really want the IMF to come in and tell you that and would you adhere to that?

Mr. CAVANAUGH. If any country whose economic situation deteriorates to the level that it subjects itself to the necessity of seeking the assistance of the international community, I think it has to accept the fact that in an international institution that exists ostensibly to create economic order, it has to accept the fact that there are going to be public policy judgments that the international community has arrived at in terms of what are sound economic principles, in order to accomplish the economic order that the international institution was created to establish among the international community.

Yes, conditions should be relevant. They should be applicable to the economic conditions that created them in their totality.

And, in fact, they are.

The IMF has long scrutinized particular expenditures. The fact is that it has not been particularly concerned. It has been more concerned about the attitudes of the governments that it was servicing than it has been about the populations who would suffer the consequences of the government's actions.

Ms. JUNZ. I am sorry. I beg to differ with that interpretation because if you take a look at the annual consultations of the IMF with various of these countries, particularly those that have been in the news lately—Jamaica, Peru, Turkey, all of these had been warned and advised years before they got to the condition that they are in today. If they had followed that advice, then, there would be much less hardship and much less loss in economic growth in all of these countries.

Chairman NEAL. And many fewer hungry babies and so forth, dying babies.

Mr. CAVANAUGH. Exactly right. Mr. Chairman, I think we are getting a little far afield. I do have some specific questions.

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Chairman NEAL. I do want to comment on this question, though, on the advisability of letting the IMF go beyond the bounds of natural sovereignty.

I will say that the view that we would be happy to have the IMF come into our country and establish our defense budget, and so on, is not one that would be shared by the majority of the Congress. I will tell you for sure.

Professor DUNN. What often is forgotten is how these countries got into trouble in the first place. What happened in Jamaica under the Manley government which required IMF conditionality? The answer is vast expenditures beyond tax receipts, a cutting away of the productive sector of the economy through various "reforms" which reduced tax revenues, large deficits in the domestic government budget, which were financed through printing money.

If the Fund has to come in and say the party is over, we are closing the bar, you do not blame the Fund for doing that. It is the government that got them drunk in the first place, to use a bad analogy.

I doubt very much that Citibank is lending to buy military airplanes. But maybe money is fungible. Some of it sneaks into that. I think it is usually nonmilitary expenditures which run rampant and which get these countries into trouble. If we do not like the way conditionality is working, we have an aid program. We can provide aid to those countries whom we think need help during the conditionality process. The World Bank has a soft loan window. The IDA is involved in this process. We could increase our contributions to the IDA. I do not know if we have yet funded what we were supposed to put into the IDA. I do not think that we have. There are lots of things that can be done other than leaning on the Fund to help developing countries that have financial troubles.

Mr. CAVANAUGH. I am not trying to lean on the Fund; I am trying to help them.

Mr. Cleveland, you stated in our earlier discussion on spreading the risk, Citibank could do it better than Saudi Arabia. It has the totality of the portfolio. And you described country lending as a little corner of the portfolio. What is Citibank's proportion of portfolio to LDC lending?

Mr. CLEVELAND. Mr. Cavanaugh, I have not got that figure in mind, but I think——

Mr. CAVANAUGH. More than a little corner?

Mr. CLEVELAND. It is a corner. I don't have the figure in mind. I would be glad to supply it to you because it depends a little bit on what countries you include.

Mr. CAVANAUGH. Well, can you give us a ball park? Your foreign lending altogether is somewhere over 60 percent, is it not?

Mr. CLEVELAND. I would guess, yes, something of that order.

Mr. CAVANAUGH. Closer to 70 percent.

Mr. CLEVELAND. I am not sure. But as I say, I will be happy to give you those numbers.

Mr. CAVANAUGH. And the LDC lending, what would you guess?

Mr. CLEVELAND. I would rather not guess because guesses are hard to pull back.

Mr. CAVANAUGH. Below 20 percent?

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Mr. CLEVELAND. I would say so, yes, but I am not positive.

Mr. CAVANAUGH. Now Governor Wallich and the Wall Street Journal, if you did happen to see that Monday article on Brazil, both make the point that the nine major U.S. banks who have carried the bulk of the recycling and the foreign lending, in particular, the LDC lending, are running up against prudent limits with regard to some countries.

I believe the Fed defines prudence as 10 percent to one country of assets for LDC's. No?

Mr. CLEVELAND. Not 10 percent of assets. I think they are talking about in relation to capital.

Mr. CAVANAUGH. Of capital, right. Is Citibank running up against country limits of loans to LDC's according to the Fed's standards?

Mr. CLEVELAND. Not that I am aware of, Mr. Cavanaugh. I do not know precisely what the Fed's standards are. In any event, I do not think it is the Fed. Is it the Fed?

Mr. CAVANAUGH. For LDC's, however, exposures, even to most of the financially stronger borrowers, would be listed if the level exceeded 10 percent of capital funds. And exposures in excess of 15 percent receive special comment in the examination reports. The largest LDC borrowers would be subject to such comment in a number of U.S. banks.

Are any of the large LDC borrowers subject to comment in Citibank?

Mr. CLEVELAND. I am not sure, Mr. Cavanaugh. As I said, I do not have those numbers.

Mr. CAVANAUGH. Could you supply us with them?

Mr. CLEVELAND. I think I could, yes.

Mr. CAVANAUGH. Would you let us know if there are any that are subject to comment?

Mr. CLEVELAND. I can supply you with the figures. You can make your own mind up about the conclusion.

Mr. CAVANAUGH. All right. You will supply us with those LDC's that are at the level or exceed the level of 10 percent of capital.

Mr. CLEVELAND. I am not sure that I can give you names of countries, Mr. Cavanaugh, under normal banking confidentiality. I will give you what I can. Let us put it that way.

Mr. CAVANAUGH. At a minimum, I would think that you could tell us how many were in that category?

Mr. CLEVELAND. Let me see what the numbers show and I will give you what I can.

Mr. CAVANAUGH. Because it is difficult for us, I would think, to make the kind of judgments that we have to make here without knowing that.

I am surprised that you would not have a more precise knowledge of the specific relationship of Citibank to your LDC borrowers.

Mr. CLEVELAND. My duties are as an economist, Mr. Cavanaugh. I am not responsible for the structure of the bank's portfolio.

Mr. CAVANAUGH. But if you are running up against country limits and—you see, the point that these articles make, did you see the article?

Mr. CLEVELAND. No, I did not see it.

Mr. CAVANAUGH. Let me just read an excerpt:

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The source says that if any major U.S. banks are already approaching their loan limits to Brazil, no more than 10 percent of the bank's capital may be lent to any one borrower.

We have to get the participation of second tier banks that aren't already committed to Brazil. There aren't any reasons why they must participate.

Would you agree with that, and Governor Wallich makes the same point. Are we approaching a time in which the nine major banks are not going to be able to continue to provide the necessary financing and we are going to have to spread the participation among the second tier of U.S. banks?

Mr. CLEVELAND. That is not new, Mr. Cavanaugh. The financing of LDC borrowing has normally for years been by means of consortium loans in which the big banks take a piece, and many other banks take other pieces.

Mr. CAVANAUGH. But the problem that Governor Wallich points out is that, meanwhile, the 15 regional banks reduced their share of the total loans to foreigners from 17.4 percent to 16.5 percent, while loans to LDC's remained constant at 18 percent.

So do you understand the problem that I have here? I am being told that the major banks are up against their limits. The demand of LDC's continues to grow. The participation of smaller banks in the United States is declining. And the need for their participation is expanding.

It creates some difficulty, doesn't it? And you don't know about those conditions.

Mr. CLEVELAND. Aren't you overlooking one rather crucial element in this? You are talking about percentages of portfolio or percentages relative to assets.

Those are not static sums.

Mr. CAVANAUGH. I understand that.

Mr. CLEVELAND. So you could stay at some percentage of your portfolio or some percentage relative to your assets and still increase your lending in terms of the total size of your balance sheet.

Mr. CAVANAUGH. I understand that and that was the point that Professor Murphy made as to why we do not need this facility. He is at variance with Governor Wallich's interpretation again, who does not believe that the capital position of the banks has improved to the extent that Professor Murphy says that it has. And he makes the point that the capital position is not expanding rapidly enough among the major banks to absorb the demand.

Do you disagree with that?

Mr. CLEVELAND. It is not clear to me that that is true.

Mr. CAVANAUGH. And you do not believe that there is going to be an expended need for participation of a second tier of U.S. banks to meet the growing needs of LDC's.

Mr. CLEVELAND. First of all, I am not clear that the needs are growing in the sense that they are growing as rapidly as you seem to suggest.

Second, I wold suppose that the banking system will manage to meet those needs. Just how that will be distributed between large, medium, and small banks and, of course, there is also the foreign banking component here, which has been growing very rapidly.

The U.S. bank's share of—I belive Governor Wallich has made that point in some remarks on his—the share of foreign banks in

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the financing of LDC loans has been growing rapidly. The share of U.S. banks has been declining.

Mr. CAVANAUGH. My final question to you would be, you have no knowledge of any cases of LDC borrowers to which Citibank is committed in which Citibank finds itself in a position of having extended itself to the prudent limits of the LDC's anticipated new capital demands which Citibank will not be able to accommodate?

Mr. CLEVELAND. No. I am sure that there are cases, perhaps a number of cases, where countries might want to borrow more.

Mr. CAVANAUGH. My question was, Are you aware of any?

Mr. CLEVELAND. I am not aware of any particular cases, no, Mr. Cavanaugh.

Mr. CAVANAUGH. In Citibank?

Mr. CLEVELAND. That fit your description.

Mr. CAVANAUGH. But you are sure that there are some?

Mr. CLEVELAND. There may well be.

Mr. CAVANAUGH. Could you advise the subcommittee of how many of those cases exist?

Mr. CLEVELAND. No, I can't, because I am simply making a guess, or giving an impression.

Mr. CAVANAUGH. Well, I mean subsequently; supply it for the record.

Mr. CLEVELAND. No. You know, I don't think it is appropriate to provide information about particular borrowers.

Mr. CAVANAUGH. I am not asking for the names of countries. I am asking for the number of situations that meet that description.

Mr. CLEVELAND. I think I would have difficulty providing that information, Mr. Cavanaugh.

Mr. CAVANAUGH. Why is that?

Mr. CLEVELAND. Because I am not sure exactly what you are after. Perhaps if you would not mind putting your question in a written form and sending it to me so that I can understand precisely what the question is you are asking, I could maybe make a judgment on that basis.

Mr. CAVANAUGH. Could I try it one more time?

The question is: Are there country situations in which Citibank currently enjoys a borrower-lender relationship in which the country is currently at prudent limits as defined by the Federal Reserve, and which would preclude further extensions of credit to that country, but in which the country has further credit needs which Citibank would not be able to meet under the constrictions of the definition of prudent lending defined by the Federal Reserve System?

Is that imprecise?

Mr. CLEVELAND. I think it is more precise than the last time. But I am not positive that I understand it fully yet. Anyway, I will have the record of this hearing and I will see what I can do about answering it. How will that be?

Mr. CAVANAUGH. Well, I think it is important for this subcommittee to have that kind of knowledge.

Mr. CLEVELAND. If that kind of knowledge can be obtained and is clearly defined, I will obtain it.

Mr. CAVANAUGH. Ms. Junz, could you answer the question?

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Ms. JUNZ. Mr. Cavanaugh. I don't have these figures, at hand. I do not want at the moment to do an exegesis on Governor Wallich's statement, but I happened to be at the conference at which he gave it.

The intent of his statement was rather more prospective than retrospective. Given the normal capital asset ratios that are observed in this country, which are higher than the ones observed in other countries, he felt that banks would have to expand their capital base if they wanted to accommodate what he saw, where the volume of prospective needs to be. Receiving equity capital would be difficult given the current price earnings, so that other ways would have to be found.

Mr. CAVANAUGH. I understand.

Ms. JUNZ. I fully agree with Governor Wallich's interpretation of the situation. As Mr. Cleveland pointed out, a lot of European banks are getting into this business. We have not talked at all in this hearing about the role of the Arab banks, which are much more risk-averse than anybody else, but which may participate in this business from here on out.

Thus, for the banking system as a whole, there may not be such a constraint. But I think is is absolutely true that there is such constraint for the U.S. banking system.

Mr. CAVANAUGH. Well, exactly. And your understanding of Governor Wallich's context is appropriate and in concurrence with my own.

My difficulty with Mr. Cleveland is that he appears to disagree with that analysis that there is a difficulty.

He has maintained throughout his testimony that both Citibank and the banking system in general are capable, prospectively, of meeting the needs.

That is in conflict with the view expressed by Governor Wallich and by others. And it seems to me that if we are going to decide as to whose judgment is soundest, it has to be based on some reference to the factual situations in which we find ourselves today.

Now there have been allegations as to the extent of the problem in news accounts of specific cases such as Brazil, in a more generalized exposition, such as Governor Wallich's. Citibank is the largest international lender, the most expository repository of the best case studies. But Mr. Cleveland is unable to assist us in capacities other than theoretical.

Chairman NEAL. Let me just say, if I can, we have had the second bells on our recorded vote in the House. And I believe we will have to adjourn the subcommittee hearings at this point.

I would like to thank all the witnesses for their excellent testimony and their significant contribution.

Thank you, again, and any other advice which you may have for us as we move along, please feel free to offer it.

Mr. CAVANAUGH. The staff has supplied me with one final question here, Mr. Chairman. Should an absolute limit be placed on a number of questions that a redhead can ask? [Laughter.]

Chairman NEAL. The subcommittee is adjourned, subject to the call of the Chair.

[Whereupon, at 12:35 p.m., the hearing was adjourned, to reconvene subject to the call of the Chair.]

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TO AMEND THE BRETTON WOODS AGREEMENTS ACT TO AUTHORIZE CONSENT TO AN INCREASE IN THE U.S QUOTA IN THE INTERNATIONAL MONETARY FUND

THURSDAY, MARCH 20, 1980

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON INTERNATIONAL TRADE,
INVESTMENT AND MONETARY POLICY,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:30 a.m. in room 2222, Rayburn House Office Building; Hon. Stephen L. Neal [chairman of the subcommittee], presiding.

Present: Representatives Neal, Cavanaugh, and Leach.

Also in attendance at the hearing: Representative Jonathan B. Bingham of New York, chairman of the Subcommittee on International Economic Policy and Trade of the House Foreign Affairs Committee.

Chairman NEAL. I call the subcommittee to order at this time.

This morning we are pleased to welcome Peter G. Peterson and Katharine Graham to a discussion of the recommendations of the Brandt Commission, on which they were the American representatives.

This Commission, under the chairmanship of the Honorable Willy Brandt of Germany, has issued a major report on policies to promote economic development in the less developed countries.

A summary of this report has been distributed to the members of the subcommittee. Among its many proposals, it includes various recommendations for improving the functioning of the international monetary system, and increasing the flow of development finance to developing economies. These recommendations are most pertinent to the work of this subcommittee, and I invite Mr. Peterson and Mrs. Graham to elaborate on them.

I am also pleased to welcome to this hearing Congressman Jonathan B. Bingham. His Subcommittee on International Economic Policy and Trade of the Foreign Affairs Committee also has an interest in these same areas of concern.

I understand that Mr. Peterson and Mrs. Graham are under some time constraints. Who would like to proceed first? Mrs. Graham, we will put your prepared statement in the record. Please feel free to read your statement, whatever you are most comfortable with. Please proceed as you wish.

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STATEMENT OF KATHARINE GRAHAM, CHAIRMAN OF THE BOARD, THE WASHINGTON POST

Mrs. GRAHAM. I wouldn't take up your time by reading it. The statement merely says what the Brandt Commission was about, that it consisted of largely political, not economic finance experts, that these people on the Commission were political figures, that they were appointed not to represent their countries or their constituencies, but to try to arrive at breakthroughs on which we could be agreed on, areas where we thought progress could be made in all these various areas where other meetings have broken down completely. What I think is kind of remarkable about the Commission report was that in many of these areas a consensus was reached, and really it is the only group that I know of where that has happened.

Minds were changed around the table. Everybody but one or two extremists really came out with quite rational kinds of recommendations.

First, the report addresses the predicaments of our global, political and economic order at a time when there is a pervasive loss of confidence, and makes recommendations that even though this is a pretty terrible time in our country and indeed in the North throughout the world, and worse in the South, to start talking about making progress in these areas. I think the report points out why it is more, not less important.

Second, it says that piecemeal actions really have not been successful, that a comprehensive approach is needed, and that one can in fact be devised that would gain broad support. That is not to say that you can do a lot of things at once, but that if you know where you want to go, that you can put the pieces in place, and make some progress.

Third, the nature of the consensus we reached includes points of agreement that really were unattainable in the sixties and the seventies. For instance, the subject of population is discussed and recommended about. There is agreement on producer-consumer cooperation on resources and commodities. There is agreement on world food and agricultural policy.

Fourth, the report is built on an analysis of the world economy that demonstrates pervasive mutuality of interest between rich and poor nations, and I think that is well described.

I think those are the main points on a particular kind of recommendation to carry out some of these things that are most being discussed. The report ends up by recommending that a minisummit of representative countries be called, and that some action be taken between the oil-producing countries and the North, and this is an idea that has arisen in many places, but I think it is again the first recommendation in an official report that there could be agreement between OPEC and the North and that this might be arrived at this minisummit.

Could I submit the prepared statement?

Chairman NEAL. Yes, ma'am. Without objection, we will put your statement in the record, or if you have additional material that you would like in the record, we would be glad to do so. Without objection, it is so ordered.

[Mrs. Graham's prepared statement follows:]

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STATEMENT OF KATHARINE GRAHAM

Chairman of the Board, The Washington Post,

before the Subcommittee on International Trade,

Investment and Monetary Policy of the Committee

on Banking, Finance, and Urban Affairs

U.S. House of Representatives

March 20, 1980

I am honored to appear before this Committee to discuss the Report of the Brandt Commission (The Independent Commission on International Development Issues). Peter Peterson and I, as the American members, not only spent two years working with our colleagues from all over the world, but we also took soundings here at home.

The results of our work may in some respects seem visionary. We took on virtually every major issue, and made recommendations. That in itself probably strains the imagination of many government

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officials, preoccupied as they are with responding to very specific crises. We suggested actions that would cost a great deal, both in terms of government budgets and in terms of industrial change in North America, Europe, and Japan. That may seem impractical at this time of fiscal austerity and creeping protectionism. We suggested bold action to bring together the rich, the poor, and the oil producers. Governments tried this in the mid-70's and failed, so the experienced and jaded policymakers may wonder what's new. Frankly, its fairly easy to dismiss the Report as politically unrealistic, from a Congressional point of view.

But this perception would miss the real significance of the Commission's work. First, and most important of all, the report represents a consensus, for the first time in memory, on the North-South issues. Not only did the members of the Commission from both the industrialized and developing countries agree. But the Commission and its secretariat sought advice from politicians, government officials, and distinguished and internationally experienced men and women throughout the world. The consensus of this report is a remarkable achievement. It tells you something that innumerable meetings of UN organizations and other institutions over the last two or three decades have been unable to say: that there are some issues and policies on which agreement between North and South is possible.

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Second, this report addresses the predicaments of our global political and economic order at a time when there is a pervasive loss of confidence -- at a time when it is widely recognized, by citizens in the street and professionals alike, that the global system of economic exchange, diplomacy, and national self-restraint is under enormous stress. As the Report states simply: "At the beginning of the 1980s the world community faces much greater dangers than at any time since the Second World War. It is clear that the world economy is now functioning so badly that it damages the immediate and the longer-run interests of all nations." We note that "Prospects for the future are alarming. Increased global uncertainties have reduced expectations of economic growth, and the problems of handling surplus oil revenues are accentrating the threat of a grave financial crisis." We entitled the Report North-South: A Programme for Survival. Hardly anyone would disagree that we are in a mess, and that "survival" is a relevant issue. But while criticisms and complaints are freely available, solutions are in short supply. The Report suggests that piecemeal actions cannot succeed, that a comprehensive approach is needed, and that one can in fact be devised that would gain broad support. In other words, something could be done which would rebuild global confidence.

Third, the nature of the consensus we reached includes points of agreement that were unattainable in the 1960s or 1970s. There is agreement on population issues, after decades of dispute,

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including agreement on the need for "national population programmes aiming at a satisfactory balance between population and resources, and making family planning freely available."

There is agreement on producer-consumer cooperation in resources and commodities, an area noted for confrontation rather than cooperation. Within this area, there is even agreement on a bold package in the energy field, involving the industrialized countries, the non-oil developing countries, and the oil producers. Mr. Peterson has discussed that package, but whatever your reaction to the specifics, you must agree that this is the first consensus recommendation involving all the parties, and as such marks a breakthrough.

There is agreement on world food and agricultural policy, an area which is normally marked by the most deep divisions imaginable among governments. There is agreement on trade policy recommendations which, if you examine them carefully, you will be surprised to find are not so different from present U.S. Government policy, even including agreement on the need for internationally agreed fair labor standards. The monetary system recommendations are not far out and threatening to the private banking system. On the contrary, they could easily be described as a middle-ground approach involving further strengthening of both public and private capital flows, and of the foreign exchange markets as well as government-to-government cooperation.

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Fourth, the report is built on an analysis of the world economy that demonstrates pervasive mutuality of interest between rich and poor nations. "Mutuality of interest," the "global village," a "shared destiny," all these catch phrases have been used in years past. But we looked into this and concluded that here was a place where rhetoric and reality were coming together. Exports of rich countries to the developing nations now have reached such levels that it can be shown dramatically that U.S., Common Market, and Japanese trade performance is tied closely to the markets of poor countries. Resource and energy flows have been threatened in the 1970s, so that all of us now know that there is a common interest in the 1980s. Wherever one turns, even to the well being of American farmers, one sees world markets, including the poor country markets, as vital to domestic well being. The poorer countries may receive some aid, and borrow even more, but they buy a lot; and they provide vital resources.

I should like to rest my presentation with these four points. This is a time when pessimism comes easily. The Report addresses our global crisis of confidence, and decades of failure to find a reasonable, broadly supported programme of action, and it concludes that something can be done: that a grave crisis requires bold leadership; that the problems may be complex and technical, but that only political action can help us break out of the present seemingly intractable positions; and that while what

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needs to be done may seem costly and politically irritating, it is all really a matter of survival.

You can argue about some of the specifics in our Report, but it is hard to argue against the need for international consensus, and concerted action, at a time when we really are faced with national and international crises of confidence.

Chairman NEAL. Mr. Peterson, please proceed as you wish. I would like to introduce John B. Bingham of the Subcommittee on International Economic Policy and Trade of the Foreign Affairs Committee. Mr. Bingham, do you have a statement?

Mr. BINGHAM. No. I am very happy to join in welcoming Mrs. Graham and Mr. Peterson. I am sorry that we weren't able to work out a comparable session for our subcommittee, but I think this will serve the purpose.

Chairman NEAL. Congressman Leach, the minority member, has joined us also. Do you have a statement?

Mr. LEACH. I don't, but I would like to welcome our witnesses.

Chairman NEAL. I would like to point out our witnesses are under some time constraints, so we have asked them to go ahead and summarize so we will have time for questions. Mr. Peterson.

STATEMENT OF PETER G. PETERSON, CHAIRMAN, LEHMAN BROS., NEW YORK, N.Y.; ACCOMPANIED BY HARALD B. MALMGREN, MALMGREN, INC., MANAGEMENT CONSULTANTS, WASHINGTON, D.C.

Mr. PETERSON. Thank you.

In recent years I have been involved in two Government-related activities that have at least one thing in common; that is, that nearly everyone is bored or irritated by both subjects. One was the President's commission on executive, judicial and legislative salaries a few years ago, and the other is this Brandt Commission on the Third World.

It may be a proclivity I have toward self-destruction to get involved in these subjects, but I was only partially amused a couple of years ago to look at how Americans ranked 14 issues in terms of relative importance in allocation of resources, I found it quite symbolic that paying more Government salaries was at the bottom of the list, and foreign aid was just above that list. I want to assure you I am not here to discuss your salaries, given that experience. One of those is one too many, as they say.

I think what I would like to do, very briefly, is point out that the hyperbole stakes are getting pretty high these days, with the greatest confrontation we have had since World War II, and Secretary Kissinger upping that "to the greatest confrontation since the Civil War." I guess as Mrs. Graham and I have lived with this problem for 2 years, as we look over the next 20 years I think we would say that this North-South confrontation could well rival those.

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If I could up the rhetorical ante myself, I would say that when you think of this potential North-South confrontation across hunger, bankruptcy, despair, and so forth, that this could well at some point become expressed in violence, and violence in the next 20 or 30 years is unlikely to be confined indefinitely to a few infiltrators on bicycles or the seizures of embassies. So I think we came out of this with a feeling that this, too, was an important crisis.

Speaking of violence, if you have time to read our report, I hope we didn't add to the rhetorical violence that has often accompanied the North-South dialog. I think all of us on the Commission agreed at some point, that much of the rhetoric in the new international order had been very counterproductive, that it had a very irksome kind of asymmetry, where we are assigned the duties, and they acquire the rights, I think we arrived at some kind of a peace pact somewhere in the middle of our Commission's negotiations that we would, as John Monnet once said to me, learn to attack our problems instead of each other. So if we have done nothing else, I hope you will notice that some of the rhetoric of the new international economic order is happily missing from this particular report.

In that connection, however, before I get to some of our substantive recommendations, I might tell you that I guess I was surprised during the course of our discussions by the depth and complexity of the political and psychological aspects of the new international economic order. Most of us with economic and business backgrounds tend to think of finance problems, debt problems, economic development problems. In terms of what I learned at least I would say I began to learn how subtle and complex the psychological aspects are.

At one point in the deliberations, just to tell a little anecdote, I suppose late one Saturday night I was probably getting rather irksome myself, and I looked at one of the more insistent members of our Commission, and I said to him:

> Tell me, sir, given the emergency nature of the problems that are facing the Third World, I would have thought that we could focus our energy on the transfer of resources issue and how we are going to bring this about. If you had to choose between transfer of resources and transfer of power, which would you choose?

It was a little bit like that Jack Benny joke, you know, where the fellow sticks the gun in his ribs and says, "Your money or your life." And there is this long pause and the fellow says, "Come on, your money or your life."

And he says, "I'm thinking, I'm thinking."

I just want to point out if I can make an obvious suggestion that came out of 2 years of weekends working on this, I would urge you in your recommendations to be almost as concerned about how things are done and how decisions get made and how the aid is transferred as what it is, and that most of us I think tend to underestimate the political-psychological aspects of this problem.

A second broad theme if I may, of what I would like to say to you today is the following. The Third World has always been what in the Nixon administration we called a MEGO subject.

You will recall that, I think: "mine eyes glaze over." I think it has been made a particularly MEGO by our inflationary economic shock at home. Therefore I think if there is another theme to the

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few things I would like to say today, it is that that issue, how do we stimulate the political will to do something about what most rational people I think looking at would agree is approaching a crisis emergency situation. How do we generate the political will to do something before it is too late?

It seems to us that the report really along that one point suggests two or three things. First, if the report has a theme, it is mutual interest and mutual gains. I don't need to tell this group that to go to the American people today and suggest to them that some large transfer of resources is called for under the name of helping others, but unrelated to the self-interests of this country is a fairly futile political activity. Therefore it is important I think for you and for the American people to ask themselves why is it in our interest. What is our benefit—our self-interest—in doing this?

I suggest if you have time to go through it, that you look at two or three issues that I think most Americans are not really much aware of.

You know about the political aspects. I am sure, Mr. Bingham, your group and Mr. Neal's both, if you look at the political horizons of the next 20 years and you look at nuclear proliferation, you look at hijacking, you look at hostages, you look at drugs, you look at all kinds of issues, you look at the Mideast, it must be perfectly obvious that the developing countries play a central role either in helping solving those problems or not obstructing their solution so there is a political mutual interest. On the economic side, where I might have a little more right to say something, let us review just two or three things.

On the exports side, which is obviously increasingly important to the developed world, I doubt very much that the American people know that we now export more to the developing countries than we do Europe, Japan, and Eastern Europe combined. I doubt that very many Americans know that if you take the 13 leading growth countries in exports to the United States over $500 million, 12 of them would be to so-called developing countries.

If you take all of the developed countries generally, you might be surprised to know that since 1974 all of the increase in manufactured goods, which is the source you know of so many of the jobs, can be accounted for by exports to developing countries.

We have here as our distinguished aid and colleague Hal Malmgren. I think Mr. Malmgren would agree that among the subjects I would urge you to look at is the concept that the developing countries may be the so-called engine of growth for the developed countries. The problem we have of stagflation is now global in nature, and in the same way that the developed countries' reconstruction in post-World War II helped stimulate the economy of all, I think it is important that we come to some judgment about the mutual interests on the economic side of helping ourselves by helping others.

On the inflation side, there is no reason to doubt why we seem so confused to the rest of the world about inflation. We say that inflation is public enemy No. 1. Yet much of the domestic rhetoric doesn't really talk about the contribution of trade to reducing inflation. This should have high relevance to the developed countries.

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For example, on textiles—and I hope I am not stepping on too many toes here—it might be interesting to observe that while there is a great deal of talk about the share of the imports that are coming from the developing countries on textiles and apparel, I got together one statistic that might interest you.

Since 1974, the increase in producer prices of textiles has risen 54 percent. The increase for all industrial products during that same period of time was 196 percent. I find it hard to believe that these imports did not both stimulate competition and lower prices.

Food production: Every study I have seen of food production suggests that if we don't dramatically increase food production in the developing countries, the prices of foods could skyrocket in the next 10 years. Again taking the mutual interest theme, if we are seriously interested in inflation at home on food, we have a self-interest in doing something about stimulating food production in developing countries, but I am sure I am preaching to the choir here.

But what I want to suggest is that as political leaders of our country, until you come to grips with the political will problem—and in my judgment that means making the case or not making the case for why it is in our self interests to do this, both economically and politically—we can have all of the hearings in the world about transferring large resources, and nothing is going to happen, because this country is clearly preoccupied and self-absorbed, like it has never been in my opinion, with its own economic problems.

A second approach that we suggest to the political will problem, or I should say the nonpolitical will problem, is the general notion that if indeed these are mutual problems, the burden should also be shared. If there were more genuine burden sharing by the entire world in helping with this transfer of resources, in other words we really conveyed the sense that we are all in it together, that it might make the political problems much easier in each and every one of the countries.

Frankly, one of the problems with the Third World development problem is that it is a long-term development problem, 20- or 30-year-type problem, and our political system finds it remarkably difficult to deal wth 20- and 30-year problems politically. Therefore, it occurred to us that instead of relying entirely on the unpredictable domestic political legislative environment in the developed countries and the OPEC countries—which I will get to in a moment—to do something about this, perhaps we should start really seriously exploring the concept that we call automatic funding, which is perhaps a benign phrase for some form of international taxation as a source of revenues.

The rationale is we are in a global economy. We all benefit, and we should all share in the burdens of that global economy. And what we talk about in our report is moving toward concepts where, to be sure, sovereign developed countries might give up some some of what has been their sovereignty in tax areas, but to the large purpose of everyone contributing in some universal and automatic way to the funding of this transfer of resources.

We mention the possibility fo international taxes on trade, for example, on travel, on communication, on resource development, indeed on arms exports, and I know this involves precedental

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issues, but I think Mrs. Graham would agree that we spend a good deal of time trying to explain to our less developed countries the enormous problem of political will that is at the heart of this problem, and how ideas that get us all in this together might be extremely helpful.

So I would urge, Mr. Chairman, that your staffs and others, if you haven't done it in any intensive way, study the universal automatic funding of this development area, rather than relying simply on year-to-year appropriations from one country to the next.

Our third broad approach to the political will problem, after much debate, we finally said to ourselves that oil and the problems that it brings about, the sudden shocking price increases, the enormous supply uncertainties, the incredible deficits, is both a cause and one of the origins of the inflationary shock that possesses the developed countries at the moment, but precisely because it is one of the origins of the problem, it might also be one of the origins of the solution to the problem.

In this last Sunday's Washington Post—I guess I shouldn't have said that in the interests of equal time to other local publications—but in that publication they summarized a general proposal dealing with the whole subject of how we might bring oil and the OPEC countries into this issue, and it is a good example, I think, of the mutual interest thing. The basic concept, Mr. Chairman, is as follows:

One thing that might well bring an American President and an American Congress to the table on the Third World transfer problem and the emergency financial problem might be the view that a real contribution would also be made to our domestic problem of oil prices, oil supply, and the basic proposition goes from there to say that there also is a lot of equity in exploring how we can combine that idea with bringing to the negotiating table, vis-a-vis the North-South, the OPEC oil exporting countries.

There is a lot of emphasis on the staggering debts in this article that I need not bore you with, but the numbers now look like they could be $650–$750 billion in 1980. Those are staggering numbers by any standard. We ask in our Commission some of the international monetary and other institutions to give us the 1985 projection of where this debt problem is heading. We have a tendency at the present time to say: Well, if we are lucky, we might get through this problem in 1980." What I am much more concerned with is what happens in 1981, 1982, 1983, 1984 compounded.

The numbers would appear to be a number like $650 billion of debt in these developing countries compared to about $250 billion at the end of 1979, and if you want we can go into this. It is covered in that statement. But looking at capital asset ratios, lending limits, and so forth, I think it is really quite unlikely that the commercial banking system in many of these countries, or at least some of them, is going to take up that burden, and then we are confronted with a first-class international crisis as to how much adjustment do these countries make, and how much financing.

But if you have a crisis of that magnitude, and if you ask yourself where are the resources in the world at the present time, and to remember that in 1980 the OPEC countries will be in current account surpluses, I believe on the order of $120 billion this

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year. To give you some easy if painful reference point, the entire value of all equities on the New York Stock Exchange is about $1 trillion, at the end of February; it would be less than that now I suppose. Thus, you are talking about adding 12 percent of the New York Stock Exchange in 1 year to this OPEC surplus, I think the fundamental idea is that we must bring the people who have the resources to this North-South negotiating table in some way.

Up to now I think many of us felt that there has not been a coherent, sustained effort to bring the oil exporting countries to the table, and let them share in this rapid growing burden of the South.

I used to kid some of our friends on the Commission who were from the oil-exporting countries, that they were brilliantly successful in an achievement of being able to be considered as brothers by the South, and you know they really do consider themselves as southerners in the North-South dialog, they continue to maintain the position that they are friends and brothers. I am sure they sincerely feel they do. Yet if you look at the aid that the oil-exporting countries are contributing vis-a-vis the ballooning debts and deficits that arise from the increase in oil prices, the debt increase is probably 10–20 times in a typical year what the aid increase is. So, the concept here is that we must do everything we conceivably can to bring them to this table.

That will involve, if our proposal makes any sense, some understandings for a 5-year emergency period on prices, gradual predictable prices, some understandings on supplies, rigorous conservation—because I think the oil-exporting countries are rightly very critical of our use of energy—and joint exploration of oil and energy in the Third World. On this last point I had some geological experts tell me what the relative drilling rate was, for example, in the Third World versus the United States, in roughly equivalent geological formulations. I was told there had been about 140 times more wells drilled in this country per equivalent potential as in the Third World. We would all benefit enormously from an expansion of oil availability from the Third World, so we bring that into this overall package.

As far as the other side of the package, which is helping the Third World, we propose that both they, the oil exporting countries, and we would step up to increase aid; that the oil-exporting countries would do some direct lending. There is nothing written in the stones that I am aware of that suggest only the western banks should do the direct lending. And that we are going to probably large new sources of funds and perhaps even some new institutions to which both the developed countries and the oil-exporting countries contribute, and this is where the transfer of power issue I would suspect will become an issue, as to how does one manage those funds or that institution.

I would hope that we would show enough statesmanship and flexibility to understand that if the resources are increasingly in that part of the world, we have to be quite willing to engage in not just a transfer of resources, but a transfer of power, that the two are likely to go together.

Now, in making a suggestion of that kind of a concordat, as we call it, between the developed countries and the OPEC countries,

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and the developing countries for the first time really, I don't think Mrs. Graham or I or anybody would like to suggest it is easy. It is rather that I was taught at the University of Chicago that if you had no alternative you had no problem, and in a curious sense, as I look over the next 5 years, I don't know what our alternatives are. That is, we aren't going to get increased oil from the United States, I don't believe, over the next 5 years. We will be lucky to keep the production where it is now.

Many of these discussions about synthetic fuels and so forth are clearly way off into the future. These debts in the meantime are ballooning to astronomical numbers. I think it is unlikely, as I mentioned, that the private banks are going to be able to assimilate this burden, nor do I necessarily believe they should in their own interest, and therefore confronted with that kind of a crisis, I think we have to be willing to explore some things that have not been thinkable in recent times.

For example, post-October of 1973 Mr. Malmgren will remember we lived under I think some dangerous illusions and delusions that somehow we could get the consumer countries all organized in some kind of power bloc. I was always mystified by that formulation, because we would refer with great casualness to how our Japanese friends would be willing to cooperate with us, and yet every time I talked to a Japanese leader or a minister, he would smile in that inscrutable Asian way as to suggest would we really be willing to confront the people supplying us with 99 percent of our energy in any confrontational way. But we lived with that illusion somehow for too long.

We have also said that we would not consider indexing. We said it 3 years ago, 7 years ago, 4 years ago, certainly. I guess as someone who has been concerned with that kind of approach, I finally got myself in the position of saying that during the next 5 years during this emergency period there are not any significant alternative sources anyway, and that I think the whole world economy might benefit from a 5-year deal of some sort, where there was at least a sense of predictability and stability with regard to the whole subject of oil—prices and supply and most certainly conservation.

Having said all that, I wouldn't deny for a moment it will be excruciatingly difficult, but that we need I think a new thrust in the direction of bringing the oil exporters into this question of transfer of resources, and it is a problem much bigger than the United States is able to handle.

Thank you. I am sorry for taking so much time.

Chairman NEAL. Thank you. I think your comments are very important and very timely. You point to several very significant problems. The problem of political will, to my observation, is a real weakness in our system. Our system is so strong in almost every other way, but we don't seem to have in our system the ability to look very far into the future. We can hardly look beyond the next election. That seems to be a major accomplishment.

Of course, you also point to the problem of there being no constituency for aid and this sort of thing, and the need for an attempt to educate the public to the benefits from dealing fairly and reason-

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ably with the developing world. Again, it is a terrible political problem, as you point out.

Last year, I guess the year before last, we for the first time were able to get OPEC to participate in a recycling scheme. That was a facility of the IMF. That seemed to work to a limited extent very well, and more of that may be possible, but I just have to ask you, you raise these problems and you are right on target, but I just have to say I think we are all aware of those problems, but we don't know the answers. Can you help us in giving us some direction in how we might get the OPEC countries to the table?

Let me just mention one other thing, if I can. First, I would like to get your opinion, specifically, if you have one on this technical subject that we are dealing with during this set of hearings, which is our increased participation in the International Monetary Fund. We are holding hearings on a bill which would increase our participation by about $5.5 billion. As you know, it is a loan that we participate in. The total of the new package, for all countries, would be about $25 billion.

I would welcome any comment on the specifics of this proposal. I would like you to comment on one other thing, if you can, and this is something I have been working on personally lately. It is a proposal for us to face up to our short-term energy supply problems. I think you correctly point out that there is no domestic supply answer to our very dangerous dependence, it seems to me, on foreign oil for the short term, and probably out at least 5 years, maybe longer.

The energy situation, as I see it, is that we are importing half of our oil, getting it from countries that are unstable, unfriendly, in some cases outright hostile, across vulnerable routes, and there are no short-term supply answers.

What I am recommending is that we unilaterally cut our imports; I would like to see us cut them about 20 percent over the next year, meaning we would have to use about 10 percent less, and I think we can do that without rationing by price and coupon. We can pass the shortfall onto the States. The States have a number of options in dealing with it. I wrote a piece on this subject to your paper, Mrs. Graham, and they still have it under consideration down there.

Mrs. GRAHAM. I will rush right back to the office.

Chairman NEAL. The trip will be worthwhile.

We have considered this in our Democratic Caucus, and we are promoting a bill that would accomplish this, and so on, but I would like to have your comment on this. It seems to me the benefits from such a policy would be enormous, that we would reduce our trade deficit about $18 billion a year, that we would wake up to the seriousness of the problem, that we would be reducing some of this pressure that you allude to experienced by the Third World countries, if we would impose some discipline on ourselves. We are 6 percent of the world population, and use 35 percent of its oil. We can certainly save a little, and I think that would be helpful beyond our own shores also.

I have taken too long, but any ideas you have on the specifics of getting some of the OPEC countries on this particular energy pro-

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posal, though I don't think there is time here to get too deeply into the question of political will.

Mr. PETERSON. So far as getting the oil exporting countries to the table, that of course is the central question, and as if it isn't complicated enough, it must obvious to everyone, and I know people don't usually like to say this, that it is hard to in turn separate that issue from the Palestinian issue. From our contacts there, it seems to me that some evidence of what the OPEC countries would consider progress on that issue is undoubtedly related to their, willingness, shall we say, unwillingness, or losing the option of using the oil weapon. These two things are obviously related in their heads, so that makes it even more complicated.

Why might they do it? Well, in the first place on the subject of an oil deal, they have talked for some time, as you know, about indexing, and we have taken the position for some time we would not index, so as Mrs. Graham and I mentioned to our two OPEC colleagues on this Commission, all we are doing is responding to your request.

Chairman NEAL. We are being indexed whether we like it or not.

Mr. PETERSON. I am talking about a mutually agreeable indexing program, not a unilateral one.

Second, I think the developing countries themselves can play a very important role in trying to persuade the OPEC countries to join this effort, since it is very much in the interests of the developing countries to get the OPEC countries, obviously, into this transfer of resources issue.

I would guess there are a number of leaders that would have to play a role on that, starting with this Commission. One of Willy Brandt's remarkable attributes, I believe, is that he has a kind of global credibility that few people have, and I think people of that quality need to talk to both the OPEC developing countries and indeed to countries like the United States in such an effort.

I would guess that it is hard to overlook someone like Indira Gandhi in this process. We have met with Mr. Waldheim and his colleagues in the United Nations. I am sure they would have to play a role, but I think, Chairman Neal, that fundamentally there is now such widespread recognition that we are facing an emergency over the next 5 years there is growing recognition of the need not just for the domestic political will, but the world's political will, in the case of two-thirds of the world, I think, could exert a lot of pressure on both the OPEC countries and the developed countries to get them, and we just simply have to try that.

I would guess, furthermore, that the OPEC countries will want to ask a variety of questions of us, just like you would. What do we do to help them with their postoil economy, if they are going to sell us this finite resource of theirs. What do we do to secure the value of their income that they get, since one of the reasons that I argue they should join us is they have an interest in the integrity of the world's banking system too. They don't need to be reminded that it is their money that is deposited in these private banks. In any event, I think the whole issue of stability of the value of their assets will be a very important issue to them.

I think the whole issue of military security is a subject of increasing interest to oil exporting countries. I think there is nothing

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worse than a bunch of independent commissioners outside of the Government getting into negotiating tactics. It is not that I am trying to dismiss the problem. I am just trying to say that the main thrust of this proposal is the oil price demand and supply problem is at the heart of the global economic and political problem today, and somewhere in that area is also part of the solution. For years we have not had a genuine dialog with the principal resource-gatherers of the world in the form of the oil exporters, and they must be part of the solution, and we must move in that direction.

It is going to be very difficult, but I don't think we have had really a sustained effort in that direction that I am aware of. Mrs. Graham may have a view too. She knows how difficult it is, but I remind you that the two members of the Commission from Kuwait and Algeria did sign the report, and this proposal is in there.

I would not say that there was instant approval of this concept, but it was in the final analysis approved, and the Kuwait member was one of the members who helped us develop this package proposal.

Mrs. Graham.

Mrs. GRAHAM. I would like to just say some words about the Bank and the Fund, and I am sure not as an instant expert on the subject, but just to report the feeling around the table on the part of the Third World toward the Bank and the Fund, some of which we came to share and some of which obviously we did not.

As far as the $5.5 billion increase to the International Monetary Fund, I am not an expert on that, but the need for funds to go through the multilateral institutions I think is a crying one. In the immediacy, the Bank and the Fund are having such a terrible time getting their funds, their appropriate funds from the Congress that I know how unrealistic it is probably to ask for $5.5 billion more.

I believe that the last time I talked to Mr. McNamara, he told me that there were only four countries that hadn't fulfilled their obligation in the new lending to the Bank, and they were incredibly, I believe—I shouldn't say this, but there are countries like Cambodia, North Vietnam, North Korea, and there were only five of them in all, Iraq I believe—I should put that down, it is not official but it is my memory that they were all countries like that—and the United States, so I understand your troubles in weighing all this.

On the other hand, it seems to me that political will can only be made by leaders, and the press can inform but really we can only lead this country from the White House, and I believe that that is where the leadership has to come from on these issues.

I think that until we perceive that our interests are at stake in doing some of these things, including the energy problem, I guess it just won't happen. I think the whole thing that you suggest of cutting down on the use of energy by use of price and, if necessary, I suppose in the end by some sort of rationing, but I think that price and State controls are certainly the place to start.

And I agree with you, it does make the Third World, and indeed it makes OPEC, angry that so much reckless use of energy is made in this country, and OPEC and the member of the Commission who came from Kuwait was one of the most violent about how it was up to this country to save energy, because both Kuwait and Saudi

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Arabia couldn't go on forever making up the deficiencies in what we need over here. I think they view this with utmost seriousness, indeed to the point of cutting of the extra amount they are supplying.

The recommendations we made, some of them, were to get funds from other areas including the further sale of gold, which we thought might be used in the same way that it has from the Fund. I am sure you have explored all those areas, but we have made recommendations about possible other areas that the Bank—what do you call it?

Mr. PETERSON. It is the gearing ratio. As we look at the capital of the World Bank, we don't think there is any question that they can probably double those gearing ratios and thereby increase their capacity to lend. The IMF has enormous amounts of gold that they can use as collateral, it seems to us. I would want to add my voice to that of Mrs. Graham, that the IMF role has been shrinking vis-a-vis world trade, and clearly I think they need more resources. May I also say that both Mrs. Graham and I spent quite a few hours with Mr. J. de Larosière and his staff, and we found him remarkably constructive with regard to the whole question of the Third World, much more so I think that I recall the IMF being 10, 20, 30 years ago.

Mrs. GRAHAM. As you know, I think both the Bank and the Fund have gotten more sensitive to the Third World, and this is one of their great complaints, that they view them, of course, as you know, as Bretton Woods institutions which fundamentally serve the North, and they are greatly interested in getting more voice on them, and I think both the Bank and the Fund are doing a fine job about bringing this about, but I think it needs to be increased, and I think that they are looking for the need of program loans, which they don't find in either the Bank—well, it is up to the Bank, I guess—but there were areas of greater cooperation between the Bank and the Fund, and the places in between where they see gaps.

The other complaint that was made at great length was about the banks, the Fund is particularly insensitive in the countries they applied this to, and of course, they avoid going to the Fund until the very last minute. There is some point that if you are the Fund, you have to introduce sensible conditionality, but they view both their people and the need for more sensitivity and more long-range possibilities before they are supposed to meet the criterion that the Fund imposes.

Chairman NEAL. Thank you. Mr. Bingham.

Mr. BINGHAM. Thank you.

First of all, I would like to say that I haven't had the chance to read the report but I have read the summary, and I was enormously impressed with the achievement of getting agreement in such a diverse group, particularly Edward Heath, to have him go along with some of the others on the Commission I thought was a perfectly remarkable, almost unbelievable achievement, and perhaps it augurs well for the possibility of getting agreement on a broader scale with some of these goals and some of the very bold proposals that you have made.

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I would like to ask whether you have given thought to the mechanism for this startling idea of international taxation. One thinks back to the problems of the Confederacy in this country in the early stages, and the fact that this was no system of taxation, because there was no Federal Government. Were you thinking in terms of some governmental organ that would be in a position to impose taxes, or rather a nation-by-nation agreement to impose taxes into a particular account?

Mr. PETERSON. Commissioners like us can only point directions. We don't have to worry about the awesome detail of how you do some of these things. But I guess generally what we were thinking of was there would need to be some kind of worldwide agreement, for example, on the various sources of contribution.

I needn't remind you that countries, for example, where the trade is a much higher portion of their GNP than others, would like to see their tax in areas other than trade, for example, and like any negotiation, where you are raising money, it will probably have to be a balanced proposal of some sort.

But in that proposal, I would have thought that there would be some kind of global agreement through one of the multilateral institutions, for example, as a potential forum, on what the percentages would be for all countries, and then as I guess with any treaty or agreement, the individual governments in consultation with their legislative bodies, I would imagine, would need to bring about the necessary tax legislation at home that would make it legally feasible for that money to be contributed to those global funds for this purpose.

As part of the agreement, you would not only need an agreement on the sources and the percentages, but you would obviously need agreement on how those funds were dispensed, since that might well have a major impact on whether you would be willing to tax. So at the very same time, it seems to me, you would have to have an agreement on the mechanism by which the funds, the conditionality, and so forth, by which this transfer of funds would be passed on to the Third World, essentially by a complex series of global negotiations, I would think, starting principally with the countries who have the resources, both the developed countries and the oil-exporting countries.

There was a proposal also that the middle-income countries, Mrs. Graham will remember, start contributing to the aid process, the Koreas, the Taiwans, and the others who are after all moving up the hierarchy. Mrs. Graham, I am sorry——

Mr. BINGHAM. Do you want to add to that on the question of taxes?

Mrs. GRAHAM. Not really. I think it is pretty far off, but I think it is an idea that will come eventually, and I think it was a good idea to introduce it.

Mr. BINGHAM. I think that is true of much of the Commission's report actually. It is certainly good to have it on the agenda. The question of transfer of power, transfer of resources and program loans all raises to me the question of whether you gave much thought to the problem which is frequently raised in our discussions here, discussions we have, and they are going on right now in the Foreign Affairs Committee, about developmental aid programs.

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To what extent do you try to control the use of those resources, and to what extent do you simply hand them over to governments?

The problem that is so often raised, and I think with some justice, is that when you go the program loan route or the broad grant route you don't do anything about the distribution of the funds within the countries themselves. Frequently the comment is made, and I think with some justification, that the result of our aid programs is to make the rich richer in countries where there is enormous disparity between the rich and the poor, and do very little for the poor. I didn't see much discussion of that problem in the summary that I read.

Mr. PETERSON. There may not have been much in the report, I have forgotten, but this whole issue, Mr. Bingham, of conditionality took many, many hours of discussion. I am sure you have heard from the standpoint of the developed countries, which is if you have aid that is not based on conditions, what assurances do you have that the aid is going to be used effectively, not just for redistribution purposes, but just effectively?

Mrs. Graham and I listened for endless hours to the view of the developing countries, that the institutions are ideological, arrogant, rigid, authoritarian, insensitive. I am sure there is a whole series of other pejorative adjectives that we heard. In that vein, let me only say that we also heard during the cocktail hours some Members tell us that occasionally they needed the institutions to put down important conditionality requirements, which in their hearts they knew were essential to make the long-term adjustment possible, but domestically for political reasons they almost needed someone outside of their system to impose the conditions.

Now, I had the feeling from our discussion at the IMF that they are moving in an appropriate direction, which is not to forget that they are a financial institution after all and not an aid institution, and to try to bring the developing countries more into the management institutions so that there is more sensitivity to their problems.

There is also growing recognition, I suppose, between the distinction between short-term emergency-type situations and in a way it is too bad that in a situation like Turkey, for example, it gets to where it is, because then it is almost too late. I think in your testimony from the World Bank, I am sure you are aware that they are now reviewing their procedures on what I believe they call structural lending, which is the longer term-type program. Before coming here with Mr. Malmgren we were discussing the growing need for increased coordination between those two institutions, on what the criteria are on the one hand for what you might call the more financially oriented short-term types of adjustment, and the conditionality criteria, whatever you call them—I am not an expert in this—on the longer term structural lending program.

I am unsympathetic to the view that you can simply transfer the money without conditions. I am unsympathetic to it because I think we all need discipline, whoever we are.

I would think that you gentlemen who are faced with one of the most onerous domestic political burdens of any committee I know, to be getting more resources transferred to these countries, about all you need to make your job more difficult, I would assume,

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would be to convey the handout concept, in which there aren't any conditions.

In that context one of the more delightful results of this Commission, as you may have noticed, there is an entire chapter called—what was it, Mrs. Graham?—"The Task of the South," or something like that, to get recognition of the fact that the developing countries also had a bunch of responsibilities we thought were important.

Mr. BINGHAM. I don't want to take up too much time. I would like to ask one more question, a rather specific one. In terms of North/South, and this being a North/South issue, where does China fit into this? China is the world's most populous country; it is going to have an increasing role. Is it South, or is it North?

Mr. PETERSON. I was assigned by the Chairman to visit with the Chinese officials on this matter, and I met with some of them while I was there about 1 year ago. Politically, I don't think there is any question but that they think of themselves as being brothers of the South and the developing countries, and you know, of course, of their very deep interest in certain regions of Africa, and so forth.

On the other hand, one has to visit there—and I don't know if you spent much time there—to realize that they feel and indeed it is a poor country with remarkably little GNP per capita. In fact, if you look at their income per capita, they truly qualify as a developing country by any standard I know. I would say when we were there, they were remarkably preoccupied—I thought understandably so—with their own shortage of resources to do the massive industrialization job they are trying to do.

And you remember last April, when we were there, there was this big cutback in their own domestic programs. So the sense that I got out of that meeting is while politically they were extremely sympathetic and interested in the developing countries, and in their growth and development, that it was very unlikely they would have substantial resources to contribute to this problem.

Mr. BINGHAM. Thank you very much.

Chairman NEAL. I would like to recognize Mr. Cavanaugh at this time and point out that it was at his insistence we had the hearings, and I would like to thank him for the idea.

Mr. CAVANAUGH. Thank you, Mr. Chairman. I want to thank you for indulging me and inviting these Commissioners here today, and I want to thank the Commissioners for taking time to come down.

I am both extremely pleased with the results of the Brandt Commission report and gratified by your presentations here today, particularly, Mr. Peterson, your commentary on political will, because I think it is the essence of the problem that we confront and the issue of maintaining and preserving a stable international economic order, which I believe is indeed on the precipice of violence and chaos that you seem to share, and also afflicted, not to use a rather distasteful word, by a "malaise" here at home, but it is a malaise at the top.

I have served on this committee now for 3 years. In the last session of Congress we addressed the issue of the Witteveen facility and supplementary financing facility, and in this session and in the course of these hearings we are addressing the issue of the sixth quota increase. In both of those events, the discussion has been

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unbelievably sparse of any inquiry into the real structural nature, and nature of the defects that exist in the international monetary order and have since 1973–74, or their remedy by the administration, by the political leadership in this country.

In fact, any discussion of it is resisted with great tenacity and the desire of the administration; the desire also complied in by the major multinational banks of this country is to minimize the destruction, add the patches onto the punctured tire, and keep on rolling without regard to the rust and corrosion that is occurring to the automobile that we are so happily cruising around in.

I think that your document is at least happily a comprehensive address for all of us now in the political process to be able to at least indicate, first, that there are massive structural deficiencies, and, happily, that it is not beyond the scope of human wisdom and political possibility to address them.

But how we get from this meager hearing—and as you may know, Mrs. Graham, you gratuitously referenced to this subcommittee that surely we have considered the leverage capacity that exists within the banks, and the IMF. Frankly, we don't hardly consider it at all. What we mostly consider is whether or not we can get a $5 billion quota increase passed without much concern of what it means to get it passed, what it means not to get it passed; and that is really the great tragedy that is afflicting this process today.

I would hope that you might have been a little firmer in some of your judgments about the IMF. I don't think that it is working. I don't see how we can say it is working and we are on the precipice of disaster. Its resources, I think, are woefully indequate, and $5.4 billion and a 40-percent increase, given the magnitude of the monetary disruptions that have occurred, is pitiful.

With the increase and with the $58 billion IMF capacity, the IMF will have 4 percent of the world trade figure to deal with, compared with 10 to 15 percent throughout all of the fifties and the sixties, so the magnitude of the deficits that need to be financed, have ballooned. The ability of the international financial institutions has dwindled, and I can't comprehend why we can't stimulate within the Treasury, with the Presidency, the will, as you say, to provide the international leadership.

From what I get from you, there is an international audience. From what I get from my own constituents, there is a domestic constituency, and somehow you and I, and the Congress, and the citizenry of this country, have to stimulate that leadership to begin to address the structural changes, to address this problem with the comprehensiveness, with the dynamism of the Marshall plan, or whatever, to capture the emergency, to make it understandable, to make that self-interest and that new world order that has been thrust upon us by disruption in 1973–74, as massive as the disruption that occurred in 1941–45.

We have the objective motivation; that is the catastrophy there that warrants dramatic action, and somehow we have to catalyze the way to do it.

If you can give us some suggestions as to how we might do that, I would be most grateful.

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Mrs. GRAHAM. I have not often heard a more eloquent persuasive statement. Maybe, Congressman Cavanaugh, you should go more public with your views, because I don't hear very many speaking quite that passionately or persuasively.

Mr. PETERSON. First, let me support what you are saying about the IMF. You are right; the number has gone from 10 percent down to about 4 percent, and even if conditions were normal, that alone would arge for substantially more. If you look at the $50 to $60 billion now in the IMF—and that is why we proposed increasing the compensatory financing, doing something with their gold, and so forth—it is trivial compared to the kind of debt problem I am talking about. The commercial debt at the end of 1979 is now about $250 billion or more; it looks like it could hit $650 billion.

You have, depending on whose numbers you believe, nearly $1 trillion in the Euro currency that did not exist 20 years ago. World trade is $1.5 trillion, or some such numbers, and these numbers are trivial.

I did not mean, and maybe Mrs. Graham and I both erred in not supporting that specific contribution to IMF which I certainly would, but I am trying to also make another point, that whatever you do now in IMF, however necessary it is, is insufficient to the enormity of this ballooning oil problem, and to go from $250 billion to $650 billion by a small increase in the IMF is not going to solve that problem, and neither are the commercial banks, in my judgment, going to solve that problem.

It is going to take a major transfer of unprecedented dimension, and that is why I believe the heart of this matter, if you want to talk about some boldness, and maybe self-destructiveness, I don't know, is we must get the oil exporting countries into this transfer process. They have not been in it. The last go-around, they added $800 million to AID for the year, and that one price increase was $12 to $15 billion. They now have a surplus of $10 billion a month, and the amount they are contributing is very small in relation to the problem, and that is the only new source of money I see that begins to be adequate to the enormity of this new problem.

Mr. CAVANAUGH. I think there is no question about that, but you can't blame them. We haven't given them the reason to do that. We haven't presented the intellectual and political and economic rationale firmly, tenaciously, comprehensively, on which they could ever possibly react.

That is our role in the world, is to devise the structure, and I think if we pass this $5.4 billion, and we most likely will, it may be struggled and kicked around here, but eventually you know, enough of the arm twisting will be done that this commitment has been made. We don't do anything for our system by ignoring those structural deficiencies, and yet this administration won't even talk about them to a committee of the Congress, let alone sell them to the world.

You know we can't even get the major banks to come down here and testify. I talked to a representative from Chase Manhattan yesterday, who refused our staff to testify. He said they testified in 1978 and felt they were getting overexposed here.

Now, how are you going to build the political will and the public comprehension of the problem and the solution, when those who

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occupy the positions of leadership and responsibility have that kind of unbelievable cautious, cavalier attitude? But I thank you for coming.

Mrs. GRAHAM. I want to reinforce what Mr. Peterson said, because I think you put us to shame, because we agree with you. I absolutely agree with you that the size of the problem—and the size of the problem in the developing world—is not appreciated, that the increase of the problem caused by the OPEC rises in energy prices is just staggering, and there isn't an adequate way of getting that over to people, and I do believe with you that the relevance of it to their lives has to come across to them.

Mr. CAVANAUGH. Thank you for coming. I think you have made a major contribution. I hope we can all do better.

Thank you, Mr. Chairman.

Chairman NEAL. Thank you, Mr. Cavanaugh.

I want to make one comment. I wouldn't want to leave the impression that because someone thinks that this $5.4 billion isn't enough, that it is insignificant; we shouldn't do anything about it. The IMF is criticized over and over again because it doesn't do enough in the way of development to help the countries, its conditionality is too strict, and so on, but the fact of life in the world is that in many cases it is the IMF or nothing. It is not a choice between the IMF and a wonderful development program. There is no development program available, and it is not the choice, between this figure, for a quota increase for the IMF, or $100 billion, or something; there is no $100 billion there.

You are aware of this. You both talked about the political problems associated with it, and the inability of us to look ahead very far. It is a significant task that we all face, I think, and I certainly commend you both for your help in this, and your dedication to this problem for a long period of time.

We would welcome your advice on any of these subjects as we proceed, and I want to thank you again for coming.

Mr. Leach?

Mr. LEACH. Let me just express appreciation for the statements of Mr. Peterson and Mrs. Graham. Unfortunately I have to leave at this point.

Mrs. GRAHAM. Mr. Chairman I think we do understand your problems, and we are trying to cut a thin line between not supporting the Bank and the Fund, which I believe we all have to do, because of what you stated, and yet there are all these additional burdens that somehow have to be looked at.

Chairman NEAL. There is no question about it. Let me make one other point: We have asked that the Fund work with the World Bank to see if they can't come up with a way of coordinating their efforts a little bit better in cases like Turkey or Peru, or some other countries that are in severe trouble by the time they get to the Fund. We don't have that yet, but we are moving in that direction. That may be of some help.

Thank you all again for coming.

[Whereupon, at 11:45 a.m., the subcommittee adjourned, to reconvene subject to the call of the Chair.]

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TO AMEND THE BRETTON WOODS AGREEMENTS ACT TO AUTHORIZE CONSENT TO AN INCREASE IN THE U.S. QUOTA IN THE INTERNATIONAL MONETARY FUND

TUESDAY, APRIL 1, 1980

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON INTERNATIONAL TRADE,
INVESTMENT AND MONETARY POLICY,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, D.C.

The subcommittee met at 10 a.m. in room 2128, Rayburn House Office Building, Hon. Stephen L. Neal (chairman of the subcommittee) presiding.

Present: Representatives Neal, AuCoin, Cavanaugh, Evans (Indiana), Lundine, Leach, Shumway, Stanton, and Porter.

Chairman NEAL. I would like to call the subcommittee to order at this time. This morning we conclude our hearings on H.R. 5970, which authorizes an increase in the quota of the United States in the International Monetary Fund.

In the course of our past hearings, much concern has been raised about the role of the private banking system in recycling the surplus funds that will accrue to OPEC over the next 2 years. Though the banks will continue to play an important role in financing the current account deficits of developing economies, they may not be able to finance as large a share of the anticipated level of deficits as they have in the past.

If alternate financing channels are not adequate, the deficits of oil-importing LDC's will fall below desired levels, to the detriment of their economic development and the health of the world economy.

One of the most important reasons for increasing IMF quotas is to enable the International Monetary Fund to play a greater role as one of these alternative channels for the recycling of the OPEC surpluses. If, contrary to expectations, U.S. banks increase their share of international lending to whatever extent might be required to insure the financing of projected non-OPEC deficits, the banks could become overextended and be saddled with a dangerous level of risk on their international assets. If those loans then suffer widespread default or rescheduling, the health and stability of the U.S. banking system could be endangered.

This morning we have invited the Honorable John G. Heimann, the Comptroller of the Currency, and Gov. Henry C. Wallich from the Federal Reserve Board to testify on a series of questions relat-

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ing to the role of the banking system in recycling the OPEC surplus. Unfortunately, we have been informed that Mr. Heimann has been unavoidably detained and could not return in time for the hearing this morning, as he had planned. In his place we are pleased to welcome the First Deputy Comptroller, Lewis Odom.

We would like to hear from Governor Wallich first and then Mr. Odom. And we would like to ask unanimous consent at this time that the complete statements of the witnesses be included in the record, and that they be allowed to summarize, if that is their desire. I would encourage that alternative, so that we might have a little bit more time for discussion of these issues.

And at this point I would also like to ask unanimous consent that we include a statement from the National Taxpayers Legal Fund in the record, and without objection so ordered.

[The referred to statement appears at the conclusion of the proceedings of this day.]

Chairman NEAL. Our ranking minority member, Mr. Leach, is here. Mr. Leach, do you have any opening remarks?

Mr. LEACH. I have no opening statement. But I would like to say that this is a very timely hearing, and I do have a number of questions for our witnesses.

Chairman NEAL. Fine.

Governor Wallich, we would like to hear from you at this time.

STATEMENT OF HON. HENRY C. WALLICH, MEMBER, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Governor WALLICH. Thank you very much, Mr. Chairman.

It is my pleasure to appear before this subcommittee to dicuss the important issue of recycling the OPEC surplus, its relationship to bank lending to developing countries, and the need for an increase in IMF quotas.

The letter from the chairman of the subcommittee inviting the Board to testify has accurately pointed to the dilemma facing the international financial system: A high level of lending by banks to developing countries could lead to excessive risk concentrations at banks, while on the other hand a low level of lending by banks may make it difficult for these countries to finance their anticipated current-account deficits. The latter situation would jeopardize the development objectives of many developing countries since these countries on balance need to import capital to supplement their domestic savings. Moreover, a lack of adequate financing flows would lead to excessively restrictive policies by developing countries to deal with external imbalances, with potential adverse effects on the United States and on other industrial economies.

The Federal Reserve has been conscious of the need to avoid excessive lending as well as the need to avoid a sharp curtailment of lending by U.S. banks. In cooperation with the other supervisory agencies we have designed our examination procedures in a manner that would allow bank participation in the recycling process, while guarding against excessive exposure by individual banks to individual countries. The new examination procedures are being implemented by the three Federal regulatory agencies.

The Federal Reserve Board also strongly supports increasing the U.S. quota in the IMF, as I stated in my testimony of March 17

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before the Senate Foreign Relations Committee on this legislation. With your permission, I would like to submit that testimony for the record.

Chairman NEAL. Without objection, so ordered.

[The referred-to testimony before the Senate Foreign Relations Committee follows Governor Wallich's statement.]

Governor WALLICH. In connection with today's testimony, I would like to provide the subcommittee with some statistical material on the general problem of bank lending and recycling which was included in Chairman Volcker's speech of March 1. And if you wish, I have given a couple of speeches on this subject that go into the particulars of the prospects of country lending. Again, if the subcommittee wishes, I would be glad to submit those.

Chairman NEAL. Without objection, the material will be included in the record.

[The material follows Governor Wallich's statement.]

Governor WALLICH. The subcommittee's letter of invitation requested comment on the factors that might constrain the role of banks in lending to developing countries in the future, relative to the role these institutions played in the past several years. Between the end of 1974 and the end of 1979, outstanding claims of banks from all countries on nonoil developing countries increased on average about $20 billion per year. During this same 5-year period, the average annual current-account deficit of the developing countries was about $26 billion, and these countries on balance added $8 to $10 billion per year to their international reserves. Subtracting bank borrowings used to finance reserve increases from total net borrowing from banks, it appears that over the last 5 years net borrowings from banks have financed on the order of about one-half of the aggregate current-account deficit of the nonoil developing countries.

The extent of new bank lending to developing countries or any other borrower is determined by the interaction of three variables: yield, risks, and concentration of credits to a borrower in the banks' portfolios. A higher yield, within limits, can compensate for a slightly higher risk. In my view, the risk premia implicit in country lending have in recent years, not been adequate. Additionally, however, as the concentration of credits to individual borrowers or borrowing countries increases in relation to a bank's total portfolio or capital, a prudent well-managed bank will demand a greater spread for a given level of risk, before it adds more of such credits to its portfolio.

With respect to U.S. banks, in the 1974–76 period the returns on lending to developing countries were quite high relative to the risks, and U.S. banks expanded their outstanding claims on developing countries as a proportion of their total assets. In the past 2 years, however, U.S. bank lending to these countries appears to have been effectively constrained by the very low yields on new credits that barely compensated banks for the costs of making and servicing the loans, much less for any risks of adding new credits to their portfolios. Thus, between 1976 and 1979, U.S. banks were less active in lending to these countries and the ratio of their claims on developing countries to their total assets actually declined slightly.

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The experience of foreign banks have been somewhat different. Foreign banks, in general, have lower levels of concentration in lending to developing countries, and, in many cases, lower capital-to-asset ratios. These banks have been willing to continue to expand their lending to developing countries relative to their assets despite the seemingly low returns because of their lower concentrations and because their lower capital-to-asset ratios allowed them to earn a higher return on capital for any given margin between their funding costs and the yield on the loans.

The rapid expansion in lending by foreign banks has caused some concern among foreign regulatory authorities. The German and British authorities have begun to require their banks to maintain detailed records on a consolidated basis including, as a minimum, lending by their head offices and foreign branches. Since last fall Japanese banks have been constrained by a request from the Ministry of Finance to limit their international lending.

Looking to the future, lending by U.S. and foreign banks will depend primarily on the extent to which spreads and fees on these loans increase relative to the increased risks and, to some extent, on the actions of bank regulatory authorities of industrial nations. The level of risks will depend in large part upon the policies pursued by the borrowing countries. If spreads and fees rise somewhat relative to the risks, then U.S. and foreign banks would be expected to increase the pace of their net new lending to developing countries relative to their assets and capital. As shown in the chart and tables that follow my oral presentation, changes in concentrations relative to assets occur relatively slowly over time in the aggregate despite large increase in outstanding claims, because the banks' assets and capital also increase over time. Changes in concentrations relative to assets do, however, occur much more rapidly at individual banks.

The willingness of banks to expand their international lending is, as I noted, highly dependent on their evaluations of the risks on these loans. Evaluating country risk in an extremely difficult task that involves complex interactions of political as well as economic factors. Compared with 1973, the developing countries' debt burdens, whether measured in real—inflation-adjusted—terms, or relative to their exports and GNP's, have increased. Moreover, in 1980 the developing countries will have a significantly higher oil-import bill than in 1979 which will absorb a substantially higher proportion of their export earnings. In addition, they will bear the indirect effects of the higher price of oil on the economies of the developed countries through reduced growth in their exports, and through higher prices for capital equipment and other imports from OECD countries. Events in Iran, Nicaragua and elsewhere have highlighted the political risks associated with international lending. Finally, there is no assurance that the OPEC surplus, and the counterpart deficit of the oil-importing countries, is likely to decline as rapidly in the early 1980's as it did several years after the 1973–74 oil price increases.

Balanced against these negative factors are the greater international reserves of the developing countries, the increased resources of the IMF, the lesser likelihood that the OECD countries will experience a widespread and severe recession as they did in 1975,

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and the lesser likelihood that primary commodity prices will fall as much in 1980 and 1981 as they did following the 1973–74 OPEC oil price increases.

Weighing all these factors is indeed complex, but, on balance, I would conclude that the general risks are somewhat greater in 1980 and 1981 than in 1974 and 1975. The situation clearly varies greatly from country to country. Recent history has taught us that the positions of some countries can improve dramatically in a very short period to time. Unfortunately, there are other cases where the external situation has deteriorated rapidly over time, either as a consequence of financial mismanagement or because of external—and sometimes internal—events over which the country has little control.

While this general background suggests it would be reasonable for banks in general to continue to increase their lending to developing countries, it would seem appropriate under current circumstances for banks to demand higher spreads to compensate them for greater risks. In the past, the risks on loans to these countries has appeared quite low, as shown by the loan-loss record on lending to developing countries by U.S. banks since 1975. However, arrearages and collection problems may be emerging for a few countries. Such problems could foreshadow some deterioration of that excellent record in the future. In such case lending spreads would be expected to increase accordingly. Some increase in spreads seems appropriate in any event, given the downward trend in bank capital ratios.

The subcommittee has raised the question of the relationship between bank capital and recycling. The Federal Reserve believes that in view of the decline in banks' capital ratios in the last few years, increases in banks' capital would be highly desirable. Bank capital adequacy, however, must be judged against the entire spectrum of bank assets and not on loans to any particular group of borrowers. Capital ratios can improve even when lending to one group of borrowers grown faster than bank capital if lending to other types of borrowers on average grows more slowly. For any given ratio of capital to assets, an important determinant of bank soundness is portfolio diversification.

With these observations in mind, it is instructive to examine the recent record of bank lending to developing countries relative to the banks' capital. As shown in table 4, the ratio of lending to developing countries to capital for all U.S. banks active in international lending in the aggregate has actually declined slightly between the end of 1977 and June 1979, although for the larger banks it has increased slightly.

If the capital funds of the U.S. banks involved in international lending were to increase on the order of 8 to 11 percent in 1980, the share of U.S. banks in the projected total new bank financing of the non-oil developing countries in 1980 could be about equal to their share of outstanding claims—about 40 percent—only with some fairly moderate increase in the aggregate ratio of loans to these countries relative to the banks' capital and assets. If existing capital-to-asset ratios were to be maintained, the additional lending would be only, very approximately, one-half as large. It would be desirable, of course, that this new lending be spread more toward

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those individual U.S. banks that are less exposed to individual borrowing countries.

In view of the active role of U.S. banks in the whole area of international lending, the Federal bank regulatory agencies have devoted substantial effort to evaluating and modifying the international examination procedures. For the subcommittee's information I would like to discuss the new procedures. The three Federal bank regulatory agencies now have a common approach for evaluating country risk in bank examinations. The system focuses on concentrations of exposure relative to capital. Foreign loans are not classified for country risk per se except in the few cases where there has been an interruption of payments or such an interruption is deemed imminent.

Data collected on the semiannual country exposure report are used by the examiners to compute exposure to individual countries by individual banks. Comments on large exposures are given in the examination report under a section entitled "Concentrations of Transfer Risk Warranting Special Comment." These comments on exposures are not a directive telling banks to refrain from further lending to a country nor are they included in the bank's asset quality rating. Rather they are designed to call to the attention of senior management exposures that are worthy of review.

In reviewing an individual bank's foreign activities, an examiner may conclude that certain exposures appear excessive in light of the position of the bank. This judgment would be based on a number of factors in addition to the level of existing exposure and the strength of the borrowers. It would take into account the bank's historical lending patterns, its management capabilities, its system for managing risk, and the size of the bank's exposure relative to other banks. In cases where the examiner judges an exposure to be exccessive, a specific criticism would be noted in the front of the examination report or cited in a letter to the bank's board of directors. These cases are expected to be relatively few in number, and usually result from some deficiency at a particular bank, rather than a general regulatory constraint on lending to an individual country.

U.S. bank regulatory authorities evaluate the foreign activities of U.S. banks on a fully consolidated basis that includes their foreign branches and majority-owned subsidiaries, drawing upon the country exposure report which is prepared on a fully consolidated basis. The reason for this approach is that loan losses at foreign branches of U.S. banks, and in most cases foreign subsidiaries, are not different from loan losses at the banks' domestic offices, since they are charged off against the earnings and capital of the parent institution.

The Federal Reserve and other regulators conduct separate examinations of foreign branches and some foreign subsidiaries. These examinations are conducted mainly to determine that the foreign offices are in conformance with U.S. regulatory policy and that their activities are being controlled and coordinated properly by their head offices.

Bank lending to developing countries or other categories of borrowers in general is not directly constrained by regulatory policy. In participating in the design of the new international examination

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policy, U.S. banks supervisors were well aware that a policy which focused on classifying countries as unacceptable risks might cause unnecessary problems for individual borrowing countries. The system that was developed avoids country classifications except in cases in which a country is not performing on its obligations, and focuses on individual bank exposure. In view of the deliberate flexibility in the examination system, there does not appear any need to modify it to deal with recycling the large OPEC surplus. However, the examination system I have described is relatively new. Based on operating experience, some adjustments and revisions may be necessary.

The subcommittee has asked for comment on whether it is reasonable to expect banks in general to continue to provide new credits to the developing countries. As shown in the attached charts and tables, in recent years foreign banks have rapidly expanded their lending to developing countries and Eastern Europe. Measured as a percent of assets, their exposure is still below that of U.S. banks so there is potential for increased foreign bank participation.

There are also a considerable number of cases of large U.S. banks that have relatively small exposures to individual countries. These banks could increase their exposure on a selective basis without bringing their risk exposure to unacceptably high levels. Moreover, participation by smaller U.S. banks in lending has been rather limited in recent years, and there is scope for increased participation by these institutions if spreads were to widen. My conclusion from the available information is that there appears to be considerable room for further U.S. and foreign bank participation in lending to developing countries.

Whether it is realistic or desirable to expect banks to participate in further lending is a separate issue. The Federal Reserve and other regulatory agencies do not want to substitute their judgment for the business judgment of individual banks. Rather, the supervisor's role is to caution banks about the risks of excessive concentration, and to make certain that banks have appropriate procedures for monitoring and reviewing large exposures. In order to help insure adequate information to the banking system, the Federal Reserve participates in efforts, such as the BIS semi-annual survey, to increase the flow of financial information to banks.

The prospects for continued bank lending to developing countries will in the final analysis depend in large part on the soundness of the international financial system and the soundness of the financial policies of the borrowing countries. Increasing the resources of the IMF, through an increase in the quotas of the United States and other member countries, would improve the ability of the Fund to meet the financing needs of its members. Increased resources for the Fund would place it in a better position to influence the policies of borrowing countries, a role that is much more appropriate for a public institution than for private commercial banks. Better coordination between the IMF and commercial banks would be desirable to prevent instances where bank credits are used by countries to avoid coming to the Fund when difficulties arise.

In view of the subcommittee's interest, I would like to summarize recent developments in our concerns relating to the Eurocurrency

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market. In the face of increased OPEC surpluses and corresponding deficits of oil-importing countries, it may well be that the scale of international financial flows will increase relative to purely domestic flows. Many of these flows will originate in domestic financial markets, but a significant proportion will involve the Eurocurrency market. These flows, through the Eurocurrency market and international bank lending, have been of increasing concern to many central banks and bank regulatory authorities. The central bank governors of the G–10 countries and Switzerland recently agreed to improve informational flows on such lending, including a general agreement that major banks of these countries should report their activities on a consolidated basis; they also agreed to increase their monitoring of developments in these markets from the standpoints of prudential considerations, as well as macroeconomic and monetary policy concerns. These measures will put supervisory authorities in a stronger position to keep abreast of market developments.

In summary, Mr. Chairman, I believe that the banking system will continue to play an important role in the recycling process. Commercial banks, however, cannot be expected to assume complete responsibility for recyclying the OPEC surplus. Countries in very large deficit will have to recognize that the need to adjust rather than to finance their external imbalances is greater now then it was after the 1973–74 oil price increases. The OPEC nations should be expected to provide more aid and direct financing, particularly since the size of their accumulated surpluses will allow them to hold a diversified portfolio of assets. Finally the IMF can play an important role in the recyclying process, but to be effective the IMF needs to be sure of having adequate resources. The Board urges the Congress to act expeditiously to increase the U.S. quota in the Fund.

Thank you, Mr. Chairman.

[The referred-to statistical material follows:]

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Table 1

Regional Current Account Balances
(Balances on Goods, Services, Private and Official Transfers; billions of dollars)

	1973	1974	1975	1976	1977	1978	1979[e]
OECD	10.1	-27.1	-0.4	-18.2	-24.8	10.9	-32
OPEC	8.0	70.0	31.0	37.0	30.0	7.0	65
Non-oil Developing Countries[1/]	-7.1	-24.4	-31.9	-20.2	-14.3	-25.7	-39
Other[2/]	-3.5	-9.5	-18.0	-13.0	-8.5	-9.5	-11
Statistical Discrepancy[3/]	-7.5	-9.0	19.3	14.4	17.6	17.3	17

1/ Principally IMF members not included in OECD or OPEC.
2/ Principally Sino-Soviet area and East European countries.
3/ The sign of the discrepancy is such that when added to the sum of the individual regional current accounts the total is zero; e.g., a positive discrepancy offsets a global current account deficit.

e = estimate.

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Table 2

Total Bank Claims on Non-Oil Developing Countries and Eastern Europe
(billions of dollars)

	December 1974[e]	December 1975	December 1976	December 1977[1/]	December 1978[2/]	September 1979
Claims on Non-Oil Developing Countries						
U.S. Banks	23.8	33.4	41.7	47.7	49.4	55.4
Non-U.S. Banks	20.0	29.6	39.2	51.1	72.3	91.8
Subtotal	43.8	63.0	80.9	98.8	121.7	147.2
Claims on E. European Countries						
U.S. Banks	3.0	3.7	5.2	6.5	6.9	7.3
Non-U.S. Banks	11.9	19.7	25.8	35.6	46.2	52.3
Subtotal	14.9	23.4	31.0	42.1	53.1	59.6
Total Claims						
U.S. Banks	26.8	37.1	46.9	54.2	56.3	62.7
Non-U.S. Banks	31.9	49.3	65.0	86.7	118.5	144.1
Total	58.7	86.4	111.9	140.9	174.8	206.8

Sources: BIS Quarterly data on banks claims and Federal Reserve and Treasury Banking data.
1/ Beginning December 1977, banks in Austria, Denmark, and Ireland began reporting to BIS.
2/ Beginning December 1978, excludes customers claims of domestic offices of U.S. banks.
e Partly estimated.

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Table 3

Financing of the Deficits of Non-Oil Developing Countries
(billions of dollars)

	1973	1974	1975	1976	1977	1978	1979[e]
Current Account Deficit	-6	-24	-32	-20	-14	-26	-39
Net Long-Term Borrowing from Official Sources	5	7	11	9	11	12	14
Net Borrowing from Banks	9	16	19	18	18	23	32
Other Net Capital Inflows	1	4	3	4	-3	3	1
Equals: Reserve Increase	8	3	1	11	12	13	8

e Partly estimated.

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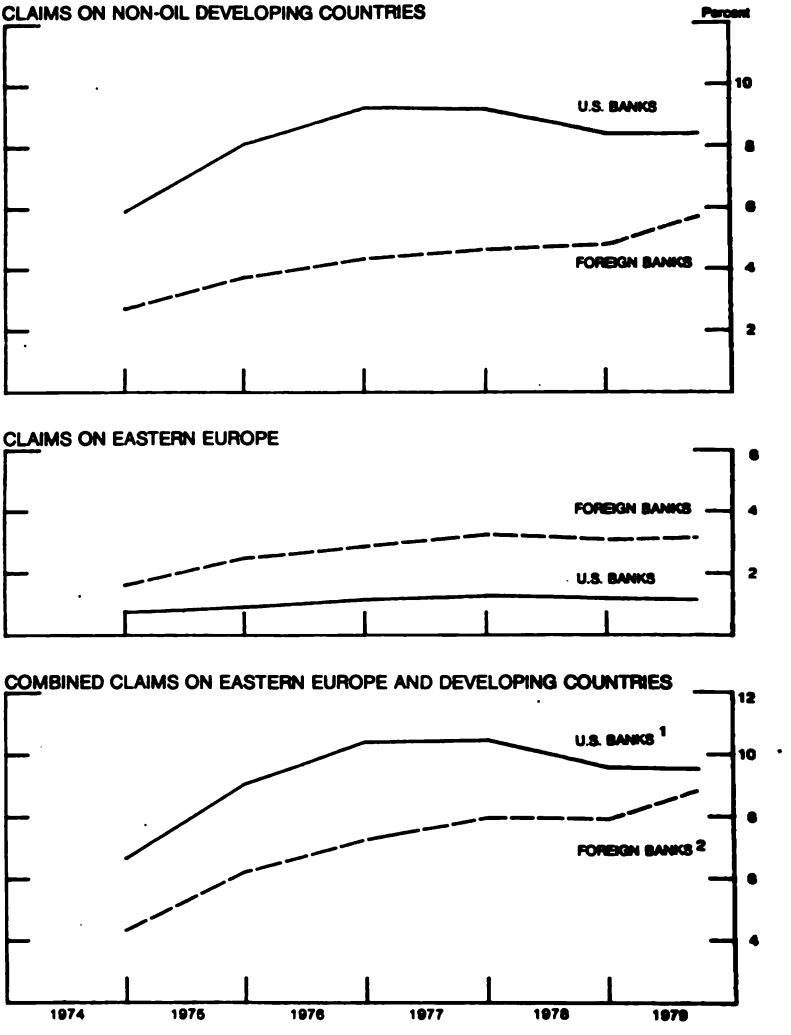
Bank Claims as Percent of Assets



1 Computed for the 24 largest U.S. banks that account for five-sixths of lending to developing countries

2 Computed for 34 large foreign banks

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Table 4

Exposure Relative to Capital for Groups of U.S. Banks[1/]
(Percent)

Country	December 1977				June 1979			
	All U.S.[2/] Banks	Nine Largest Banks	Next Fifteen	All[3/] Others	All U.S.[2/] Banks	Nine Largest Banks	Next Fifteen	All[3/] Others
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Non-oil Developing	115	156	105	61	112	161	109	53
Argentina	6	9	5	3	7	10	7	4
Brazil	30	40	28	16	28	39	28	14
Mexico	28	32	29	21	21	27	23	14
Philippines	5	7	6	2	6	10	7	2
South Korea	8	12	6	4	11	17	10	4
Taiwan	7	10	6	3	7	10	7	3
Subtotal (6 countries)	84	110	80	49	80	113	82	41
Eastern Europe	18	25	16	9	15	21	15	7
Combined Total	133	181	121	70	117	182	124	60

1/ Exposure after reallocating claims from country of obligor to country of guarantor. Capital defined as equity, subordinated debt, and loan-loss reserves.
2/ All 128 U.S. banks completing the Country Exposure Report.
3/ Remaining 104 U.S. banks completing Country Exposure Report.

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Table 5

Estimated Disposition of OPEC Surpluses
(Billions of dollars)

	1974	1975	1976	1977	1978	1979e
Estimated Current Account Surplus	70	31	37	30	7	65
Investments						
In the United States	12	10	12	9	1	7
In the United Kingdom	8	*/	-1	1	*/	2
In the Eurocurrency Market 1/	22	8	13	12	3	38
In international financial institutions	4	4	2	*/	*/	-1
Subtotal	46	22	26	22	4	46
Unidentified investments (net)	24	9	11	8	3	19

e Estimate
*/ Less than $0.5 billion.
1/ Including minor amounts of domestic currency banks deposits outside the United States and United Kingdom.

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Table 6

Debt Service Obligations of Non-Oil Developing Countries
on Medium and Long-Term Public Debt
(billions of dollars)

	1974	1975	1976	1977	1978	1979[e]
Debt Service[1/]	8.7	10.6	12.9	17.2	27.0	33.0
Interest payments	3.1	4.2	5.1	6.3	8.9	12.5
Amortization	5.5	6.3	7.8	10.9	18.1	20.4
Merchandise Exports	96.3	92.0	113.1	134.9	152.4	189.0
Ratios:						
Debt Service/Exports	9.0	11.5	11.4	12.7	17.7	17.5
Interest payments/Exports	3.2	4.6	4.5	4.7	5.9	6.6

e Estimate.
1/ IBRD reports

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Table 7

Spreads and Maturities on Syndicated Bank Loans to Non-Oil Developing Countries and Eastern Europe

Date		Average Spread[1]		Average Maturity[2]	
		Non-oil Developing	Eastern Europe	Non-oil Developing	Eastern Europe
1973:	Q_4	1.17	.59	10.8	8.8
1974:	Q_4	1.46	3/	7.5	3/
1975:	Q_4	1.82	1.49	5.4	5.5
1976:	Q_4	1.90	1.33	5.1	5.5
1977:	Q_4	1.76	1.16	7.3	6.0
1978:	Q_4	1.04	.75	9.8	6.7
1979:	Q_1	.94	.89	9.9	7.3
	Q_2	.79	.78	9.0	6.8
	Q_3	.80	.78	10.1	7.2
	Q_4P	.91	.63	8.4	8.8

1/ Unweighted data on spreads in basis points on syndicated bank loans to nine developing and four Eastern European Countries.
2/ Average maturity from date of credit agreement to date of final repayment.
3/ No credits granted.

Source: International Bank for Reconstruction and Development.

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[Governor Wallich's referred-to testimony before the U.S. Senate Committee on Foreign Relations on March 17, 1980, and the speeches—one entitled "The Future Role of the Commercial Banks" presented at the Conference on New Approaches and Techniques for Managing Country Risk, New York, N.Y., January 24, 1980, and the other entitled "American Banks Abroad in 1985," presented a the banking forum sponsored by the Government Research Corporation, London, England, on March 11, 1980, follow:]

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Statement by

Henry C. Wallich

Member, Board of Governors of the Federal Reserve System

Mr. Chairman, I appreciate the opportunity to appear before the Committee on behalf of the Federal Reserve Board in support of the legislation, S. 2271, currently before Congress to approve a 50 percent increase in the U.S. quota in the International Monetary Fund. Prompt passage of this legislation is in the interest of the United States and will help to maintain a smoothly functioning international financial system. Failure to act promptly would weaken both substantively and symbolically U.S. leadership in the international community.

An increase in the resources available to the IMF at this time is essential if the Fund is to continue to play a central role in dealing with the unprecedented scale of payments imbalances that its members are facing. The United States, with more than a fifth of the total quotas in the Fund, is the largest member of the IMF, and the Fund cannot continue to function effectively without commensurate U.S. participation in its financial operations.

The IMF is a broadly based international financial institution, including industrial and developing countries, oil-exporting and oil-importing countries, and even several centrally-planned economies in its membership. Its importance in facilitating the efficient functioning

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of the international monetary system is growing. It has been assigned major new functions and responsibilities in recent years, including expanded surveillance of economic policies and exchange-rate practices of its members under the second amendment of the IMF Articles of Agreement. An IMF substitution account is currently under active consideration and negotiation; this would add further to the responsibilities of the Fund. The U.S. Government has been in the forefront in broadening the responsibilities of the Fund, and concrete support in the form of Congressional approval of the quota increase would position the Fund to handle an expanded role with a stronger financial position and with enhanced authority.

Active U.S. participation in the IMF is in the U.S. national interest. The United States benefits directly from a financially strong IMF because it may want to draw on the Fund in the future, as it did in 1978 as part of the November 1 package of anti-inflation actions. In an environment of increased international financial strains and increased sensitivity of the U.S. economy to developments abroad, the United States also benefits indirectly from the IMF's efforts to alleviate such strains. In many instances, without temporary financial assistance from the IMF, countries would be forced to take severe adjustment actions that could have a disruptive effect on the international economy.

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With the introduction of new IMF facilities and changes in its operating procedures in recent years, potential access by members to the Fund's general resources has increased considerably and appropriately. More significantly, however, in view of the adverse impact of the higher oil prices on the external positions of many countries, the need for short-term balance-of-payments financing in coming years may well increase dramatically. The IMF should be in a position to meet substantially increased calls on its resources, and the proposed increase in IMF quotas would broaden the financial base of the Fund and help it to do so.

The Fund's resources have experienced a considerable erosion in relation to the growth of the world economy over the past 10-15 years. By 1977, when the most recent quota review began, total quotas in the Fund, for example, had declined to about 4 percent of the value of world imports compared with more than twice that proportion in the 1960's. Developments since 1977, especially the increase in countries' oil import bills and the general effect of inflation on the value of imports, have reduced the ratio of IMF quotas to world imports even further. Since an additional increase in IMF quotas is not now planned for another five years, the proposed 50 percent increase in quotas barely would maintain the current size of the Fund's resources in relation to the expected growth of world trade in the period ahead.

Because of recent disturbances to the international economy that had not been anticipated at the time the quota increase was negotiated in

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1978, the proposed increase is a minimum step toward meeting the enlarged prospective financing needs of the IMF and its members. The world economy once again is confronted with the problem of dealing with the financial consequences of a huge OPEC current-account surplus and the accumulation of vast reserves by OPEC members, together with magnified current-account deficits for most oil-consuming countries. In a speech earlier this month, Chairman Volcker focussed on the implications of those financial flows -- often called the recycling process. He expressed the hope that the IMF would play a major role in the recycling process that lies ahead. With your permission, I would like to submit a copy of these remarks for the record. The observations on the recycling process should help to place the role of the IMF in the current situation in a somewhat broader perspective.

The strengthening of the financial position of the Fund resulting from the increase in Fund quotas is an essential element in preparing for the strains that may well develop on the international financial system in the next year or two. The role of the Fund under the current circumstances will not only be important because of its financial resources, but also because through the good offices of the IMF there is a better chance to achieve a better mix between adjustment and financing of the huge external imbalances the world economy faces.

Higher IMF quotas do not mean a reckless increase in liquidity that will be frittered away. Resources provided by the IMF typically have

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been used constructively, and IMF members have an excellent repayment record. An encouraging development in recent years has been the increase in the number of countries adopting stabilization programs as part of stand-by credit arrangements with the Fund. Among developed countries, Great Britain and Italy benefitted from IMF-assisted stabilization programs in recent years, and an increasing number of developing countries can point to the successful turnaround of their economies in large part because of the stabilization programs that they implemented in conjunction with a stand-by arrangement with the Fund. At present, some 24 countries are covered by IMF credit arrangements that are conditioned upon their adherence to policy performance criteria. The Fund's leverage in continuing to encourage its members to introduce necessary adjustment actions in conjunction with drawings on IMF credit facilities will be heavily dependent on the Fund's possessing sufficient resources to continue providing such credits.

In recent years, the International Monetary Fund has been viewed by some as an aid institution offering long-term development loans. This is a mistaken view: the IMF is designed to provide short-term balance-of-payments financing assistance to all its members, developed countries as well as developing countries. When the Fund provides financial assistance, it must have a reasonable assurance that the associated adjustment programs will be successful in assuring repayment

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and in enabling the IMF to maintain the "revolving fund" nature of its operations. Conditionality associated with drawings on the Fund that often are large in relation to a member's quota, therefore, are appropriate and necessary.

The IMF, however, has come under increased criticism by some who claim that it has been too harsh in its policy advice. It is true that IMF-sponsored stabilization programs often require substantial economic retrenchment by borrowing countries, involving at times political and social costs for such countries. Restrictive adjustment measures in most instances, however, are necessary in order to correct the underlying imbalances that have led to the need for balance-of-payments assistance in the first place. The need for such corrections does not come from the actions of the Fund, but rather from those actions inside and outside the country that bring about the unsustainable external deficits. Some of the difficulties associated with such stabilization programs could be eased if resort to the Fund came earlier, before the situation has worsened to the point where drastic action is required. However, in order to encourage members to come to the IMF, the Fund's resources must be ample, and the terms of conditional credits must be otherwise attractive.

Although the IMF will be expected to assume an expanded role in the recycling process ahead, the actual amount of resources provided by the IMF will remain small in relation to total financial needs. Inter-

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national credit markets, and especially credits from private commercial banks, have played an important role in recent years in channelling funds from countries in surplus to countries in deficit. We have every reason to expect that these markets will continue to play a major role in providing credits to finance external deficits in the period ahead. At the same time, the IMF should play a strategic role in helping create the economic conditions in borrowing countries to attract private capital flows and maintain access to credits from banks.

One potential danger in the recycling process that must be avoided, however, is the overloading of the commercial banking system. Ratios of loans to developing countries to banks' capital or assets of U.S. banks have declined slightly over the past two years. For foreign banks, loan ratios have risen, but based on the latest available information they remain lower than for U.S. banks. Thus, in the aggregate, it would appear that there remains some leeway for prudent increases in loans to developing countries by U.S. and foreign banks without raising their exposure ratios to excessive levels, particularly since the capital and assets of banks also would be expected to increase. The capacity and willingness of the banking system to provide additional financing to developing countries, however, will vary greatly from bank to bank and will continue to depend on the condition of individual borrowers and the terms of the loans. Emerging problems seem likely, as in the past,

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to remain limited to a small number of countries. In response to increased risks, lending spreads may well widen and maturities may shorten.

Given the expected increased demands for balance-of-payments financing, as well as the large external indebtedness that many countries already have with commercial banks, the IMF should be in a position to meet a larger proportion of the immediate financing needs of its members in the coming years than it has assumed recently. A strengthening of the Fund's financial position by the increase in members' quotas would increase the likelihood that more countries would come under the Fund's conditional-lending umbrella. Such a development, in turn, would promote greater complementarity between IMF financing, other official financing, and private bank lending to such countries. At the same time, the increased capacity of the Fund to finance payments imbalances of its members does not in any way relieve public and private borrowers and lenders from their responsibilities -- on the one hand for servicing outstanding loans and on the other for care and informed judgment in deciding on new commitments.

It would be desirable that when authorities in borrowing countries see trouble ahead that they consult with the IMF promptly to develop a program that will maintain their creditworthiness. It also would be helpful if commercial banks, when they recognize that a liquidity

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problem is developing in one of the countries borrowing from them, would urge the country to seek the advice of the Fund, as well as the Fund's assistance in working out a smooth transition to a more viable rate of external financing. The constructive role of the IMF also could be reinforced if commercial banks were to structure their lending policies so as to support the Fund's role in the adjustment process.

In sum, in light of the serious problems that the international economy is facing, it is essential that we equip ourselves adequately to meet the challenges ahead. We will have to work on a number of fronts simultaneously, particularly pursuing sound macro-economic policies that succeed in curbing inflationary pressures, adopting effective energy policies, improving international cooperation and consultations, and strengthening international institutions such as the International Monetary Fund.

At this time, about 29 percent of the IMF membership, with nearly a quarter of the total quotas in the Fund, already has given parliamentary approval to the increase in IMF quotas from about SDR 39 billion (about $50 billion) to about SDR 58 billion (about $75 billion). For the proposed increase in quotas to take effect, members with three fourths of the Fund quotas must give their approval by November 1, 1980. Without U.S. participation, therefore, there is little likelihood that the quota increase could be implemented. Prompt approval by Congress of the

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legislation increasing the U.S. quota in the IMF would spur other countries to consent to increases in their quotas. An increase in the U.S. quota from SDR 8.4 billion (about $10.9 billion) to SDR 12.6 billion (about $16.3 billion) would reaffirm the U.S. commitment to an open international financial system and to the key role of the International Monetary Fund in fostering the smooth operation of that system. In view of the important attention that is being directed at reducing the size of the United States budget deficit, I would add that under the alternative budgetary treatment approaches that the Treasury currently is discussing with interested Congressional committees, U.S. payments on its quota subscription would not affect net budgetary outlays or, therefore, the Federal budget deficit.

Enlarging the financial capacity of the Fund at this time by putting in place the proposed increase in IMF quotas will strengthen the Fund's influence in promoting over time balance-of-payments adjustments by those members that are facing increased external financial difficulties. Access to ample Fund resources and associated financing by developing countries, in particular, should help these countries to avoid having to make large and abrupt reductions in their growth rates and imports. If these countries are compelled to cut imports sharply, the United States and other industrial countries will feel the economic effects. Moreover, financing by the IMF would reduce temptations by countries to adopt

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protectionist measures to deal with their external payments problems, a step that would be contrary to their own longer-term best interests and to the interests of their trading partners, including the United States.

The proposed IMF quota increase, thus, will benefit both the United States and the international financial system. The Federal Reserve Board, therefore, urges prompt approval by Congress of the legislation increasing the U.S. quota in the International Monetary Fund.

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THE FUTURE ROLE OF THE COMMERCIAL BANKS

Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

at the conference on

New Approaches and Techniques for Managing Country Risk

New York City

January 24, 1980

I am happy to have this opportunity to address the seminar on managing country risk. The topic once more has become a timely one. Two-and-a-half years ago, some of us participated in a symposium on "financing and risk in developing countries," the organization of which, like that of the present seminar, also was in the capable hands of Steve Goodman.

Some of the problems that we have to discuss today are quite reminiscent of those of mid-1977. Curiously, however, this is in good part not because the problems have persisted, but because, after at least in some degree having gone away, they have now come back with a vengeance. By that I mean, of course, that in 1977 we were still concerned with the problems created by the oil price rises of 1973-74. One pressing issue was the allocation of OPEC-induced current account deficits. Should the deficits end up in the LDCs where the capital inflow might be most needed, or in the industrial countries that could best finance them? In the period following, the surplus of the OPEC nations largely vanished, a massive deficit appeared in the United States and disappeared again, and the developing countries continued to grow, thanks in large part to continued heavy bank borrowing. Now the OPEC surplus is back bigger

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than ever. One factor, however I believe, has changed significantly: the ability of the banking system to handle the ensuing deficits on the terms and conditions to which the market had become accustomed in the meantime.

During the last two years or so until very recently, the market has become very much a borrower's market. Minimal spreads, a severely compressed differential among spreads for different borrowers, longer maturities, and the large size of loans all document this condition. There are several reasons why this situation is likely to change. They lie both on the side of the borrowers and of the banks. On the side of the borrowing LDCs there is, first, the higher burden of oil imports. This comes on top of an already visible increase in burden of debt relative to the ability to carry it. At the new level of oil prices, the oil import bill will absorb, on average, one-third of the export receipts of oil-importing LDCs in contrast to an earlier one-sixth. This leaves less available for debt service as well as for payment of other imports. It changes, in other words, the meaning of a given debt service ratio.

There is, second, the previous rise in the burden of debt. This rise is by no means spectacular, but neither can it continue to be overlooked. Aggregate foreign debts of non-oil LDCs approximately tripled in the five years from 1973 to 1978 and rose perhaps an additional 25 percent in 1979. These rough numbers ignore unrecorded short-term debt, which adds to the burden, as well as the growth of foreign exchange reserves, which reduces it. But the proportionate increase in the debt would hardly be much altered if these variables, which probably rose on roughly the same scale during the period, were taken more fully into account. Since oil-importing developing countries experienced substantial inflation in their

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foreign trade prices -- perhaps 70 percent in export unit values and 80 percent in import unit values -- the increase in debt burden in real terms is a good deal less. What is more, the real interest rate paid by the average borrower was probably negative. LIBOR (London Inter-Bank Offer Rate) for 90-day dollar obligations averaged 7.9 percent over the years 1973-78, as against an average price increase of about 11.0 percent. Only in 1979, did LIBOR at 12.0 percent exceed a rise in the price of primary products (excluding oil) of 10.4 percentage points. Of course, the experience of some countries is bound to have differed from these averages. Because of these differences, the real interest rate, defined as the nominal interest rate minus the expected rate of inflation over the life of a loan, in an international context, is less meaningful than in a domestic context.

But despite negative real interest rates, the familiar debt ratios have tended to increase. From 1973 to 1978, the average ratio of gross debt to GNP rose from 17 to 23 percent, that of net debt (after deducting reserves) to GNP from 11 to 17 percent, and debt service requirements to total exports rose from 14 to 17 percent, for a group of 99 non-oil LDCs. Recognizing the wide variance of these ratios among countries, as well as great differences among countries in their ability to handle debt, and keeping in mind also the limitations of any form of ratio analysis, these data nevertheless signify some deterioration up to the end of 1978.

It is at this point in the story that the rising price of oil threatens to raise the deficit of non-oil LDCs from $25 billion (including official transfers) in 1978 to perhaps $50 billion (including official transfers) in 1980. To me, this suggests a different response to the problem of deficits than was widely adopted in 1973-74. If at that time the principle was to finance rather than adjust, today it may need to be reversed. Many developing countries will be well advised to stress balance-of-payments adjustment in preference to additional

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financing. Some adjustments are already underway, as witness the devaluations in Brazil, Chile, and Korea. Such adjustments should be easier to make in today's environment than in 1974-75 because world economic activity is better maintained presently than it was then.

My main concern here today, however, is with the lenders rather than with the borrowers. How much of the borrowing of the developing countries will the bank be able and willing to handle? Outstanding claims on non-oil LDCs of all banks reporting to the BIS rose at an average rate of 23 percent per year from December 1975 through June 1979. Such a rate of growth exceeds, of course, the rate of overall credit expansion that can be sustained by any banking system not in the grip of galloping inflation.

For instance, total bank credit in the United States, over the same 3-1/2 years, grew at an average annual rate of 10.9 percent. Shifts in the composition of assets, implying faster growth of some and slower growth of other components are, of course, always going on and are indicative of the flexibility of the banking system; but as particular components, such as LDC loans, come to constitute an increasing share of the total, their growth necessarily must slow down. Thus, the rapid growth of LDC lending had some of the characteristics of the filling of a vacuum. Lenders, borrowers, and regulators all have an interest in seeing that this vacuum is not converted into a compression chamber. That is implicit in the dynamics of any growth pattern. In the case of bank lending to non-oil LDCs, it is the consequence also of particular limitations encountered by banks in terms of their risk exposure with respect to particular borrowers and their overall ratio of capital to assets.

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U.S. banks already have substantially slowed their lending to developing countries. Between December 1975 and June 1979, their share in total international claims on non-oil LDCs of banks reporting to the BIS dropped from 54 percent to 38 percent. Their share in annual net new lending (after repayments) dropped from 46 percent ($13 billion) to 15 percent ($6 billion). The U.S. bank share in claims on oil-exporting countries dropped from 52 percent to 35 percent; their share in net new lending dropped from 58 percent to 5 percent.

The substantial slowing that has taken place in LDC lending by U.S. banks sometimes is overlooked when attention is focused on the geographic location of the lending office instead of on the nationality of its control. For example, U.S. balance of payments data on bank claims cover all banking institutions located in the United States, including the U.S. agencies and branches of foreign banks. Thus, while these data are useful for capital flow analysis, they do not necessarily reflect the office of the bank responsible for the lending decision, nor the country of the bank which bears the ultimate exposure to risk on a loan. Control of lending policy, as well as risk exposure, of course, runs to the bank's head office independently of the country in which the landing office happens to be located.

The slowing of LDC lending by U.S. banks no doubt reflects in part their often-voiced concern about the inadequacy of spreads on syndicated Eurocurrency credits. It reflects also the stronger demand for funds in the U.S. domestic market. Finally, it may reflect tightening monetary policy and rising interest rates in the United States as well as greater monetary ease in many foreign countries, although to the extent that

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foreign banks make dollar loans, the volume of their lending is also influenced by U.S. monetary policies.

Capital ratios and LDC risk exposure of American banks may also be assumed to have played a role in their decision to slow LDC lending. The ratio of equity capital to total assets of the nine U.S. banks with the most international business, after improving from a low of 3.7 percent in 1974 to 4.3 percent in 1976, once more deteriorated to 3.9 percent by mid-1979. Bank earnings have been inadequate to keep bank capital growing in line with the inflation-driven volume of bank assets. Assuming a dividend payout of one-third, banks would have had to earn 18 percent on assets in order to keep up with the approximate 12 percent average growth of bank assets during the years 1976-78 if they are to rely almost exclusively on retentions. But new stock issues, which could relieve this situation, have been very difficult to make, given the very low price/earnings ratios characteristic of leading American banks. These reflect, in turn, the market's realization that the real value of bank capital and, therefore, bank earnings is reduced by a factor of about 3/4 of the going rate of inflation, making allowance for nonmonetary assets equal to only about 1/4 of capital that could protect that capital against inflation.

Foreign banks in many instances are less constrained by capital than are American banks and thus can accept lower spreads. In some countries, lower capital ratios than in the United States are characteristic of most banks. In some countries also, foreign banks receive better protection against inflation by a greater ownership of nonmonetary assets such as participations and real estate. Maintenance of capital ratios has been easier for such banks because a better inflation protection

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of earnings has permitted stock issues. In some countries, finally, banks are owned and backed by their government.

But it is probably in terms of risk exposure with respect to particular borrowing countries that U.S. banks have encountered some of their most obvious limitations. The in-house country limits set by banks, arrived at normally on the basis of careful country risk analysis, are, of course, fairly flexible. But banks nevertheless have to watch carefully their concentration ratios, which are monitored by means of the Federal Reserve - FDIC - Comptroller of the Currency's country risk evaluation system. These focus on the percentage of capital exposed to risk in each particular country. For most industrial countries, regulatory considerations are not particularly inhibiting. Exposures over 25 percent of capital funds in any such country are "listed" in examination reports, but usually no comment on such exposures is made. For most G-10 countries, lending by many U.S. banks exceeds 25 percent of capital.

For many LDCs, however, exposures even to most of the financially stronger borrowers, would be "listed" if the level exceeded 10 percent of capital funds, and exposures in excess of 15 percent receive special comment in the examination reports. The largest LDC borrowers would be subject to such comment in a number of U.S. banks. Comment does not necessarily imply that there is an inherent credit weakness, but is made to alert management to exposure levels. While banks are not prevented in any way from making loans to LDCs in excess of the comment level, a decision to raise exposure significantly is properly one to be taken in full awareness of the facts by senior management. Qualitative differences in exposure, as inherent for instance in the difference between short-term, trade-related credits and long-term, syndicated loans, are important.

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If banks with exposures above the comment level wished to avoid an increase in these exposures, their lending could increase only in proportion to the growth of their capital, i.e., roughly on the order of 10 percent of present lending levels. For the group of banks having much the largest part of the loans to Brazil and Mexico, for instance, such an internal decision would mean an increase in loans to Brazil of about $1.5 billion over the next year.

Broader participation in LDC lending by larger numbers of banks would help to make more flexible the supply of bank loans for LDCs. The reduction in the share of U.S. banks in this lending, accompanied by strong expansion, at least until recently, by banks of many other countries, represents one such form of diversification. However, within the confines of U.S. banks, there has been no broadening of participation in foreign lending generally. On the contrary, the share of the nine largest money center banks in loans to foreign banks and nonbanks remained virtually unchanged at 68.2 percent in December 1977 and 68.6 percent in June 1979. The share of these banks in loans to LDCs stood at 63.9 percent and 64.5 percent during the same period. Mesnwhile, 15 regional banks reduced their share in total loans to foreigners from 17.4 percent to 16.5 percent while that in loans to LDCs remained constant at 18.7 percent. Other banks, accounting for relatively small amounts, reduced their share of lending to LDCs.

So far, the slower LDC lending by U.S. banks seems to have been compensated by more aggressive lending on the part of the banks of other countries. If the slower expansion of LDC lending by U.S. banks has continued since mid-1979, there would nevertheless be room in the

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portfolios of banks in other countries or the obligations of creditworthy LDCs. Most of the large non-U.S. banks still appear to have a lower ratio of foreign assets to total assets than do large U.S. banks. They should be able therefore to accommodate a relative increase in foreign lending. It seems likely though, that lenders will have to be offered better terms and that borrowers may have to look toward adjustment rather than financing to an increasing degree. In this regard, it might be noted that Japanese banks have recently also curtailed their foreign lending.

For the longer run one must ask whether the world's banking system can meet increasing demands by the LDCs even if these demands reflect genuine investment financing rather than the financing of consumption-oriented oil imports. The banks have, in a sense, pioneered LDC lending. Their lending practices have many desirable attributes that would make a continued strong role of the banks in LDC financing constructive.

There is no shortage of funds in world financial markets, thanks not only to OPEC surpluses, but to the demonstrated ability of the Euromarkets to draw funds from all over the world by offering attractive interest rates. Nor is there a shorage of high quality assets in which OPEC and other surplus countries, if there are any, could invest these surpluses. The difficulty resides in recycling these funds toward the deficit countries, where they would be at some risk. It seems incumbent on OPEC to assume some of the risks inherent in the process.

New forms of bank pioneering may be needed. For instance, banks might take on the role of arrangers or brokers of loans. The risk of

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such loans would fall on the ultimate lender, instead of a bank substituting its own credit for that of the borrower. Such activities would not strain the banks' capital ratios.

The IMF may have to play a larger role. Banks have been partly at fault in creating a situation in which the IMF has been brought into the financing picture only after the banks have vanished from the scene as willing suppliers of a weakening borrower's credit. Banks have seemed to act as if countries were either creditworthy, in which case they got all the money they wanted, or they were not, in which case no further credit was offered. Some form of cooperation with the IMF, which would strengthen the borrower's performance through IMF conditionality, would be preferable to such an all or nothing approach. As we look toward the longer-run future, more new forms of LDC financing, will probably need to be developed.

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AMERICAN BANKS ABROAD IN 1985

Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

at the

Banking Forum

sponsored by the

Government Research Corporation

London, England

March 11, 1980

I am glad to have this opportunity to address this banking forum dealing with U.S. banking in 1985 on the topic assigned to me, "American Banks Abroad in 1985." The topic presents a temptation. When the immediate outlook is obscure, it is often easy for the speaker to raise his eyes to the hills beyond and to engage in speculations and forecasts that are not likely to catch up with him for some years. But our first job is to get to 1985. I shall, therefore, devote most of my remarks to more immediate concerns.

The New Deficits

The setting of our problem is familiar. A very large new OPEC surplus and corresponding deficit for the oil-importing countries has come into existence. This surplus is not likely to shrink as quickly as did its predecessor of 1974 vintage, owing to the more limited

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prospective absorption by the OPEC. The ability of many developing countries to increase their debt at the same rapid rate as in the past is in doubt, because of the mounting burden of existing debt. So is the ability of the commercial banks to expand their LDC lending as fast as in the past, because of the levels of exposure already reached.

Let me make clear immediately what these premises do not mean. They do not mean that OPEC countries cannot find investment outlets for their surpluses. They do not mean that developing countries' deficits cannot be financed. They do not mean that a massive governmental effort must be launched. They do mean that we need to take a close look at some of the parameters of the situation in order to instrument an approach.

To begin with, it is not altogether true that the OPEC surplus is in some sense immutable. It depends in good part on the action of the importing countries in conserving energy, developing substitutes for imported oil, and moderating their rate of growth. Given the prevalence of inflation around the world, the need to avoid excessive expansion for this reason coincides with the need to slow down oil imports.

Given, however, an OPEC surplus of very considerable size for several years, there remains open the question which countries are to have the corresponding deficits. This depends, of course, on the preferences among oil-importing countries as between balance-of-payments adjustment and balance-of-payments deficit financing, and on the ability to finance desired deficits. If the erstwhile heavy borrowers have to slow down their borrowing somewhat, it seems likely that a correspondingly larger part of the worldwide deficit will land with the developed countries. The

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mechanism that would bring this about is the slower growth of developing countries' economies and therefore of their imports. This would slow down the exports of the developed countries and, other things equal, shift the OPEC-induced deficit in their direction. Of course, there may be other factors causing deficits to shift around including anti-inflation policies on the part of developed countries.

I am aware, of course, that slower growth of the developing countries has implications for their ability to carry past as well as prospective debt. Debt is relatively easy to carry so long as the rate of growth of the debtor's income exceeds the rate of interest he has to pay. Given that bankers tend to measure debt capacity in good part by the borrower's income, it becomes possible, under these conditions, to borrow continuously in order to pay the interest on previous borrowings. But borrowing to pay interest is not a good practice, even if it does not raise in the borrower's mind the question why he is doing this. The purpose of borrowing should be, of course, to increase investment and growth. But for that very reason borrowing, that may have as its main purpose the payment of oil bills, must be kept very firmly under control.

In this context I would like to remind you that even if a loan is made for the specific purpose of financing some particular investment project, that may not be its true economic effect. A high-priority investment project is likely to find financing from one source or another, if not from international borrowing, then from the country's own resources. What a foreign loan finances, in an economic sense, is the borrower's marginal outlay, which may be a much lower priority investment project or quite simply consumption imports.

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Developed countries, with their generally stronger economies, will find it easier to borrow in order to finance deficits. For some of them, deliberate borrowing will be unnecessary because capital inflows from OPEC will meet their needs. With close to $100 billion to be placed in 1980 and amounts perhaps not much smaller for some subsequent years, many countries will experience substantial capital inflows from OPEC through one channel or another.

The Role of Banks

This brings me to the role of the banks in this process. The ability of banks, especially American banks, to absorb additional country risk, relative to capital, may be diminishing. This does not mean, however, that they could not accept substantial additional OPEC deposits or make LDC loans in significant volume. The banks could afford to increase their balance sheet totals particularly if they place a part of the additional funds in a very high grade of assets, such as their home government's short-term securities. This, of course, would limit the interest rates they could pay on their liabilities. In turn, that might make OPEC less inclined to place funds with such banks. OPEC might decide instead to buy those high-grade securities directly, as indeed is happening to some extent today. It is sometimes argued that if OPEC does not get an adequate rate of return, it might simply cut back the production of oil, and I shall revert to that matter later. Here I just want to note that a reduction in the supply of oil would in all probability increase rather than reduce OPEC's total receipts, so that the investment problem would not go away while great

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economic damage might result to OPEC investments. The way to reduce oil receipts, which OPEC is not likely to choose, is to increase oil production and drive down the price.

Purchase by OPEC of high-grade primary securities would in some degree solve OPEC's investment problem. It would not solve the recycling problem. The second leg -- moving the money out to where it is needed -- would remain to be solved. Frequently, it is suggested that a larger input from official financing will be needed to deal with this aspect. In this connection, it is worth noting that the International Monetary Fund today has substantial liquidity.

As far as the banks are concerned, I would like to draw your attention to the fact that, in the field of international risk taking, we seem to be going through a very significant phase in the process that governs the acceptance of risk. There can never be long-lasting stability in the evaluation of risk. So long as no major losses occur, lenders are likely to conclude that their earlier evaluation of risks has been too high. Greater risks will then be incurred and smaller risk premia will be charged, as we observed during the second half of the 1970's. Stability in the credit markets necessarily breeds instability. The process of acceptance of higher risks continues until there is a shock to lender confidence. We have now experienced such something of a shock. I agree with those many observers who see this leading back to more cautious lending policies, including shorter maturities, higher spreads, and greater differentiation among borrowers.

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As banks reevaluate their lending policies, I would draw your attention also to the role that the high level of LIBOR (London Inter-Bank Offer Rate) has played in influencing spreads. The allowance for the cost of capital that the spread must cover if an additional loan is not to reduce the bank's capital ratio, diminishes as LIBOR rises. A higher part of the cost of capital is covered by the loan -- in addition to paying for the cost of the money -- when LIBOR is high relative to the cost of capital. One could regard this as a partial explanation of why spreads fell as LIBOR rose, although other factors no doubt predominated. These spreads will be increasingly inadequate, however, when and if LIBOR declines.

Given the lengthening of maturities that had occurred before the recent change in the perception of risk, many loans are outstanding that will be tested in a variety of ways during their lifetime. Movements in LIBOR are likely to be only one such dimension. Granted that even the longest syndicated bank loans are of substantially shorter maturity than the lifetime of most investment projects and in that sense therefore sub-optimal, borrowers have had to recognize that that is the nature of commercial bank loans.

Substantial changes in economic conditions, perhaps a serious depression, cannot be ruled out over a period of 10 or more years. Political changes, and changes in the quality of economic management in some of the borrowing countries, must also be reckoned with. That is why historic debt standards and ratios retain their value even if in the case of particular countries, at particular times, bankers see reasons for going beyond them. And, given the unforeseeable character even of many short-run

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events, let alone those occurring over 10 years, diversification remains the cornerstone of risk management.

For that reason, I would be concerned, for instance, if recent events in the market should lead toward greater specialization by banks of different nationalities in loans to particular groups of countries. Risk diversification would suffer in consequence, and concentration would arise. This is applicable particularly to American banks, for whom supervisory analysis of country-risk concentration is one of the key features of the examination process. As I noted on a previous occasion, for loans to many developing countries, exposures in excess of 15 percent of capital even to most of the financially stronger borrowers receive special comment in the examination reports. The largest LDC borrowers would be subject to such comment in a number of U.S. banks. Comment does not necessarily imply that there is an inherent credit weakness, but it is made to alert management to exposure levels. While banks are not prevented in any way from making loans to LDCs in excess of the comment level, a decision to raise exposure significantly is properly one to be taken in full awareness of the facts by senior management. Qualitative differences in exposure, as inherent for instance in the difference between short-term, trade-related credits, and long-term, syndicated loans, are important.

Bank Capital

Banks can put themselves in a better situation to accept additional country risk if they can increase their capital more or less proportionately. For American banks, however, new issues of stock are very difficult at this time because stocks of large banks are selling at price-earnings ratios of

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4-6 and in a number of cases below book value. The market is putting this low valuation on bank stocks, in the face of rising and historically very high nominal earnings, I believe, not because it sees great risks ahead, or because of its evaluation of bank management. It does so, in my opinion, because bank capital is being eroded by inflation. Under inflation-adjusted accounting methods, this erosion must be deducted from bank's rate of return, with proper allowance for any nonmonetary assets the bank may own, to arrive at an inflation-adjusted return. The Financial Accounting Standards Board is now requiring American banks to present a supplementary statement in their annual reports showing the loss from inflation. You can find it somewhere in the back of annual reports, although, to the extent I have been able to observe, the inflation loss there shown is not integrated into earnings to the point of showing adjusted earnings after the effects of inflation. A pencil, not even a calculator, will do the job for you that the market has done all along. That will explain why banks that own little real estate or other hard assets are losers from inflation. They are compelled to invest in paper assets not only all their liabilities, but most if not all of their capital, and inflation takes its toll.

Short of issuing new stock, banks are dependent for increases in their capital on retained earnings. In the Euromarket, they must raise capital via the spread. Retentions have indeed been rising along with the rate of return on capital, which before inflation adjustment now ranges around 13-15 percent for some of the largest banks, in one or two cases higher. But since inflation also drives up bank liabilities, capital ratios, after some improvement in 1976, have tended to resume their long-term downtrend.

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Banks of other countries may be in a different position. In some countries capital ratios were lower to begin with, in some countries banks are better protected against inflation by ownership of real estate, participations, or other nonmonetary assets. In the absence of consolidated balance sheets, and in the presence of hidden reserves, comparisons are difficult to make.

A New Approach -- Banks as Brokers

The growing concentration of country risk and the shortage of bank capital, at least in the case of American banks, suggests the possibility that on occasion banks might try to act as brokers instead of as lenders of funds, provided the suppliers of the funds can be persuaded to accept the risk. Prototypes for such techniques are numerous. In the United States, banks have created mortgage-backed pass-through securities, and in Switzerland banks employ their trustee accounts. Both techniques have the effect of economizing on bank capital. OPEC lenders generally seem to have favored low-risk investments, but they have also indicated concern that they were not getting a positive rate of return on their investments. Conceivably, a developing country might be willing to do what developed countries would hardly consent to: an indexing of liabilities. Some developing countries have had experience with indexing. The indexing presumably would have to be in terms of a price index for the currency of the loan, whether dollars, D-mark, or any other. A very moderate interest rate which would constitute a positive real return should be adequate given the indexing. A weighted index could even be constructed for an SDR loan, if such further reduction in risk were preferred by the lender. From the borrower's point of view,

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the risk implied in the indexing would not be very much higher than the risk inherent in a commitment to pay LIBOR.

It seems not inconceivable, therefore, that a mutually satisfactory arrangement could be made whereby OPEC made loans directly to developing countries under conditions compensating them for the risk, arranged by banks with the use of their expertise in evaluating loans. Presumably the banks, as evidence of good faith, might want to take a share of the loan.

1985 and All That

Finally, let us take a look at U.S. banks in 1985. A not unimportant problem, as I said to begin with, is getting there. A look ahead over such a time span involves only one certainty -- that things will be different from what one expects. But if all goes well, I would expect, by 1985, American banks to have overcome most of the problems I have described. Inflation should have come down, bank capital ratios and the rate of return on bank capital should have adjusted in such a way that retentions of profits would largely take care of growth requirements, perhaps with some assist from an easing of the McFadden Act restrictions which at present prohibit branching and merging across state lines in the United States. I would expect banks to be implementing or at least contemplating new forms of financing, if their regulators are wise in allowing them to move with the times. I would expect the Euromarkets to be under better control than today, with some recognition that monetary authorities cannot indefinitely allow their currencies to be created outside their reach by foreign banks or foreign branches of their own banks. And some time in 1985 I would expect an enterprising arranger of conferences to be organizing a meeting on the topic of banks in 1990.

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Chairman NEAL. Thank you very much, Governor Wallich.

At this time we would like to hear from Lewis Odom, First Deputy Comptroller of the Currency.

STATEMENT OF LEWIS ODOM, FIRST DEPUTY COMPTROLLER OF THE CURRENCY

Mr. ODOM. Thank you, Mr. Chairman. I am pleased to appear before the subcommittee today to testify on the role of U.S. banks in the recycling of OPEC surpluses, particularly to less developed countries. We do join the Treasury Department in supporting H.R. 5970, to provide a 50-percent increase in the U.S. quota in the U.S. International Monetary Fund as outlined in the previous testimonies of Secretary Miller on March 10 before the Senate and former Under Secretary Solomon on February 4 before the subcommittee.

The increased IMF quota will insure that the Fund is adequately endowed to help finance growing international payments imbalances and, more important, will permit the Fund to help manage the adjustment processes now required for all oil-importing nations.

A dramatic oil price increase which was initiated by OPEC in 1974, began a process of fundamental change in the world economic order.

The OPEC nations as a group experienced aggregate current account surpluses of $175 billion in the period 1974 through 1978.

These surpluses were matched by deficits on the part of the rest of the world as a whole, nonoil exporting LDC's experienced accumulated deficit of over $115 billion between 1974 and 1978.

Not all of the LDC deficit is attributable to oil; some of it results from their need to import capital for economic development, program purposes, energy substitution projects, and so forth.

This past year we have witnessed another substantial oil price shock. The price of oil went up 87 percent in 1979 and still more in early 1980.

Nonoil LDC deficits expanded by 50 percent, reaching a level of almost $40 billion.

In 1979, LDC's as a group borrowed a total of $32 billion from banks with U.S. banks apparently providing about 25 percent of this credit.

Projections of future OPEC pricing decisions and the size of the OPEC current account surpluses and the size and composition of current account deficits in the rest of the world must involve an element of conjecture.

Most forecasts of the 1980 OPEC surplus fall in the range of $100 to $120 billion. Forecasts for subsequent years are more divergent because of varying assumptions about the degree and speed of adjustment to demand to higher prices, OPEC production levels, and OPEC's plan to spend its revenues on imports.

Forecasts of current account deficits in nonoil exporting LDC's as a group and in individual countries display similar degrees of variation.

Management of the changes in the world economic order resulting from OPEC's actions can be accomplished in a variety of ways. One of these is a process of adjustment in which world demand for OPEC oil is reduced. A second possibility is action by OPEC such as

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increased imports or direct investment in the economies of deficit nations.

Various private institutional investors such as pension funds and insurance companies could provide a third alternative by serving as a financial vehicle for managing the recycling process.

Fourth, the international financial institutions such as the IMF are a possible vehicle for financing the deficits of the LDC's. The multilateral approach has the effect of spreading risk globally. A major recycling program concerns maturity transformation.

The LDC's require relatively long-term financing for adjustment and economic development purposes. The preference of OPEC for relatively short-term deposits in the major banks exacerbates the maturity transformation of funding, risk to those banks, and extending long-term credit to the LDC's.

The larger U.S. commercial banks will continue to play a role in the recycling process. Among the considerations that will be brought to bear in determining how active that role will be are the legal and regulatory framework, the bank supervision process, the capital position of the banks, and the risk-reward relationships in the international credit market with the legal and regulatory framework. An important statutory provision of the National Bank Act generally prohibits a national bank from lending an amount greater than 10 percent of its capital or surplus to any one borrower.

State-chartered banks are, of course, subject to State laws, which generally include lending limitations.

Although lending limitations do not explicitly restrict exposure in any one country, they do have the effect of buttressing the concept of diversification of source of repayment, a long recognized practical and prudent principle of sound lending and portfolio management.

In April 1979, the OCC adopted an interpretive ruling regarding the application of statutory lending limits to loans by national banks to foreign governments and their agencies.

A feature of the ruling recognizes the fact that a single source of repayment exists in some circumstances, even though a government may use different borrowing entities.

This is a common practice among developing countries which often had relatively centralized economies and a multiplicity of economic development agencies.

The bank examination and supervision processes are sensitive to the added dimensions of risk involved in foreign lending. The three commercial Federal bank regulators have adopted uniform examination procedures for evaluating and commenting on country risk factors in international lending by U.S. banks.

The interagency country exposure review committee uses quantitative and qualitative information obtained from banks and other sources to assess the relative strengths of different countries.

The committee's judgments as they relate to the portfolio of each bank are brought to the attention of bank management through the bank examination process.

Our task as regulators is to balance the banking system's observations and conclusions on individual countries with our own independent judgments to assure through the examination process that

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portfolio diversification is a demonstrated practice and to evaluate each bank's system for assessing country risk.

Risks involved in lending to any one country or group of countries are constantly changing.

In addition to the economic factors, the stability of the political system, the potential for social unrest, and the external and internal management of the countries' financial affairs, are but a few of the concerns that must be evaluated when assessing the degree of risk and lending to borrowers in a foreign country.

Countries, in general, including LDC's, display a firm resolve to repay, since failure to do so would likely bar them from access to external capital for many years following a default or repudiation of their debt.

However, I think it is important to note that the sensitivity and perception of banks with regard to political risk is increasing.

Assessments of the future role of U.S. banks and lending to LDC's involves the following considerations. What level of risk will attach to the loan? Will the return on the loan compensate for that level of risk, as well as yield an adequate profit?

Will the capital of the bank be able to support the level of risk involved? How will the loan fit into the bank's long-term pattern of customer relationships? The economies of several of the more prominent LDC borrowers have grown rapidly in the past decade.

In addition, their holdings of foreign currency reserves have increased.

These two factors presumably strengthen their ability to repay. A cloud on the horizon concerning their ability to repay, however, is the possibility of weak economic performance in the industrialized countries on the next few years.

The LDC's are dependent upon exports in order to earn the foreign currency needed to service external debt. Serious economic slowdown in the industrialized countries would reduce the demand for LDC exports and hence, adversely effect their ability to repay.

In the Eurocurrency market, where most LDC borrowing takes place, rates are generally set in terms of a margin or spread over liability. When the perception of risk is greater, wider spreads are required to attract lenders.

Maturity is another aspect of loan terms related to risk with greater perceived risk generally requiring shorter terms to elicit lenders.

There is evidence of a tightening of terms in the Eurocurrency market in recent months. Inflation-induced asset growth has narrowed the capital asset ratios of the larger U.S. banks, which would lead them to require tighter terms in lending to LDC's as compensation for deploying additional capital against risk assets.

A tightening of lending terms will have a significant bearing on the willingness of individual bank management to increase the present level of international lending. If profit margins widen, it is generally expected that some U.S. banks will significantly increase their international loan portfolio.

Even if interest margins do widen, however, it is not likely that there will be a dramatic increase in the number of U.S. banks engaging in international lending. The role U.S. banks will play in

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future lending to LDC's will be jointly determined by the interplay of their own capital positions.

The lending terms established in the Euromarkets relative to the profit opportunities at home, the long-term relationships between the banks and their LDC customers, prospective economic conditions in the LDC's and the industrialized countries, and perceptions of the political risks in lending to them. The same financial and economic considerations which will affect the role of U.S. banks in future lending to LDC's will also affect the behavior of the major foreign banks.

They will also be influenced by domestic conditions in their home country markets and by the attitudes of the central monetary and bank regulatory authorities in their home countries.

In light of the current uncertainties surrounding future policy developments in OPEC, the LDC's and the industrialized nations, the need for international cooperation becomes all the more evident. Here the importance of the IMF's role as forum and executor is clear: It is desirable to have international financial institutions adequately endowed for the tank of supplementing and complementing the private marketplace.

We therefore support the proposed 50-percent increase in the U.S. quota of the International Monetary Fund.

Thank you, Mr. Chairman.

[Mr. Odom's prepared statement follows:]

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PREPARED STATEMENT OF LEWIS ODOM

FIRST DEPUTY COMPTROLLER OF THE CURRENCY

BEFORE THE
SUBCOMMITTEE ON INTERNATIONAL TRADE, INVESTMENT
AND MONETARY POLICY
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES
APRIL 1, 1980

I am pleased to appear before the Subcommittee today to testify on the role of U.S. banks in the recycling of OPEC surpluses, particularly to less developed countries (LDC's).

We join the Treasury Department in supporting H.R. 5970, to provide a 50 percent increase in the U.S. quota in the International Monetary Fund. As outlined in the previous testimonies of Secretary Miller on March 10 before the Senate and former Undersecretary Solomon on February 4 before this Subcommittee, the increased IMF quota will ensure that the Fund

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is adequately endowed to help finance growing international payments imbalances and, more important, will permit the Fund to help manage the adjustment processes now required in all oil importing nations.

The Record 1974-78

The dramatic oil price increases initiated by OPEC in 1974 began a process of fundamental change in the world economic order. The OPEC nations as a group experienced an almost nine-fold expansion of their aggregate current account surplus, which rose from $8 billion to $70 billion from 1973 to 1974. In the subsequent four years the annual OPEC current account surplus declined to a low of $7 billion in 1978 as the OPEC countries undertook substantial import programs and inflation reduced the real purchasing power of their oil revenues. Despite the decline in the OPEC current account surplus in the 1975-78 period it still cumulated to $105 billion, bringing the total for 1974-78 to $175 billion.

These surpluses were matched by deficits on the part of the rest of the world as a whole. The industrialized OECD countries experienced a cumulative deficit over this period of almost $60 billion, although the experience of deficit was not uniform across OECD countries. The non-oil exporting LDC's experienced a cumulative deficit of over $115 billion between

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1974 and 1978. (Not all the LDC deficit is attributable to oil - some of it results from their need to import capital for economic development program purposes, energy substitution projects, and so forth.)

In the 1974-78 period OPEC members invested $58 billion in the Eurocurrency market and additional amounts in the domestic financial systems of OECD countries, including $44 billion in the U.S. In this period, the non-oil exporting LDC's borrowed $94 billion from banks.

During this period the LDC's as a group enjoyed rather strong economic growth, with some of course doing better than others. As a group, they also added some $40 billion to their international currency reserves.

1979 and the Future

The past year has witnessed another substantial oil price shock. The price of oil went up 87% in 1979 (and still more in early 1980) and OPEC surpluses for the year expanded nine-fold from the previous year, reaching a level of $65 billion. Non-oil LDC deficits expanded by 50%, reaching a level of $39 billion. In 1979 the LDC's as a group borrowed a total of $32 billion from banks, with U.S. banks apparently providing about 25% of this credit.

Projections of future OPEC pricing decisions, the size of the OPEC current account surpluses, and the size and

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composition of current account deficits in the rest of the world must involve an element of conjecture. Expert opinion diverges rather widely.

Much of the divergence stems from assumptions about the price of oil. Since a $1 shift in the average price of oil results in about a $10 billion shift in the OPEC surplus, different assumptions about prices have significant effects on other aspects of the forecast. Most forecasts of the 1980 OPEC surplus fall in the range of $100 billion to $120 billion, with some observers forecasting a surplus as low as $75 billion and as high as $140 billion. Forecasts for subsequent years are even more divergent because of varying assumptions about the degree and speed of adjustment of demand to higher prices, OPEC production levels, and OPEC's plans to spend its revenues on imports. Forecasts of current account deficits in the non-oil exporting LDC's as a group and in individual countries display similar degrees of variation.

Management of the changes in the world economic order resulting from OPEC's actions can be accomplished in a variety of ways.

One of these is a process of adjustment in which world demand for OPEC oil is reduced. This can be accomplished through a reduction in economic growth on the part of oil importing countries, an increase in their energy efficiency,

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development of other sources of energy as substitutes for OPEC oil, or some combination thereof. Since the adjustment process works through reducing the demand for OPEC oil, it affects the size and timetable of the recycling problem.

Another possibility is action by OPEC, such as expanded OPEC imports or direct investment by OPEC in the economies of the deficit nations.

Various private institutional investors such as pension funds and insurance companies could provide a financial vehicle for managing the recycling process. These institutions generally have long term liabilities and therefore can take on long term assets such as loans to LDC's without creating an undue mismatch of maturities on the two sides of the ledger. Their participation in such a program, however, is constrained by legal, fiduciary and diversification of assets considerations.

The international financial institutions such as the IMF are a possible vehicle for financing the deficits of the LDC's. Indeed, the international financial institutions have already been involved to some extent in such activities. The multilateral approach has the effect of spreading risk globally.

This is especially important inasmuch as the larger private commercial banks of the major industrial nations serve as the primary financial intermediary system between the OPEC

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surpluses and the rest of the world's deficits. A key problem with this mechanism, in addition to problems of credit risk, is maturity transformation. The LDC's require relatively long term financing for adjustment and economic development purposes. Yet banks fund themselves with relatively short term liabilities. The preference of OPEC for relatively short term deposits in the major banks exacerbates the maturity transformation, or funding, risks of those banks in extending long term credit to the LDC's.

Nonetheless, whatever the size of the OPEC surpluses and the LDC deficits, the larger U.S. commercial banks will continue to play a role in the recycling process. Among the considerations that will be brought to bear in determining how active a role the banks play are the following:

- the legal and regulatory framework
- the bank supervision process
- the capital position of the banks
- risk-reward relationships in the international credit market.

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The Legal and Regulatory Framework

The rise in bank credit to the LDC's by U.S. and foreign banks from the $40 billion range in 1974 to over $150 billion today has attracted considerable attention from bank supervisory authorities in various industrial countries, including the U.S.

The activities of U.S. banks are significantly guided by our legal and regulatory framework. In the international lending context, an important statutory provision (12 U.S.C. 84) of the National Bank Act generally prohibits a national bank from lending an amount greater than 10% of its capital and surplus to any one borrower. State-chartered banks are, of course, subject to state laws, which generally include lending limitations. In some significant cases, such as New York, these limitations differ from those which apply to national banks. Statutory lending limits have the effect of buttressing the concept of diversification of source of repayment, a long recognized, practical and prudent principle of sound lending and portfolio management.

In April 1979, the OCC adopted an interpretive ruling regarding the application of statutory lending limits to loans

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by national banks to foreign governments and their agencies. A feature of the ruling recognizes the fact that a single source of repayment exists in some circumstances even though a government may use many different borrowing entities. This is a common practice among developing countries, which often have relatively centralized economies and a multiplicity of economic development agencies. The interpretive ruling sets forth publicly the criteria which will be applied in determining whether foreign public agencies and instrumentalities are relying on a common source of repayment and warrant treatment as a single borrower.

Lending limitations, however, are not directly related to country exposure. In the national banking system there are no statutory limits that restrict aggregate exposure in any one country. The general principle of diversification, however, is particularly relevant to international lending because assessment of country risk is so difficult.

The Bank Supervision Process

The bank examination and supervision processes are sensitive to the added dimensions of risk involved in foreign lending. The three Federal commercial bank regulators - the Comptroller of the Currency, the Federal Reserve Board and the Federal Deposit Insurance Corporation - have adopted uniform examination procedures for evaluating and commenting on country

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risk factors in international lending by U.S. banks. Country risk in bank lending refers to the possibility that economic, political or social factors within a country might create a situation in which borrowers in that country would be unable to service or repay their debts to foreign lenders in a timely manner. The concept of country risk embraces virtually all external currency credits to countries, whether to public or private borrowers.

Determinations regarding country risk factors are made by an Interagency Country Exposure Review Committee. The Committee consists of nine members, two regional bank examiners and one headquarters representative from each agency. The Committee meets three times per year.

Prior to each Committee meeting, the examiners hold discussions regarding those countries selected for review with bankers from their respective regions. These discussions center on both the bankers' assessments of the risks involved and their attitudes toward further external currency lending to each country.

The Committee uses quantitative and qualitative information obtained from banks and other sources to assess the relative strengths of different countries. The Committee's judgments,

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as they relate to the portfolio of each bank, are brought to the attention of bank management through the bank examination process.

Generally, risks do not differ significantly between loans extended from domestic bank offices and those extended from foreign offices. The methods and procedures utilized by banks and bank examiners for evaluating risk relating to foreign borrowers are essentially the same. There is, however, one additional element of risk to loans booked abroad to a borrower in a different foreign country. This is the possibility that events in the jurisdiction where the loan is booked may interfere with orderly repayment even though there is no interruption in the borrower's ability or willingness to repay. Loan agreements may provide protection against this. The Interagency Country Risk Committee process assesses this aspect of risk where relevent.

The Interagency Country Exposure Review Committee and the attendant examination procedures emphasize diversification of exposures to individual countries as the primary method of managing country risk in international portfolios. We believe proper diversification of loan portfolios provides the best protection for the banking system against a dramatic turn in the economic or political fortunes of a country or group of countries. Decisions on whether to increase or decrease

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exposures to borrowers in a particular country are the responsibility of bank management, within the parameters of the legal lending limits which pertain to the bank.

An additional important aspect of country risk concerns concentrations within a portfolio. Concentrations may exist not only with respect to individual countries but also whenever repayment is dependent on an identified common source. There are situations where loans are made to varied borrowers, well dispersed individually and geographically, yet, repayment rests, for example, with the export of a common commodity. Therefore, repayment of all the loans is dependent upon the common factor of the borrowers' exports of the same commodity at a certain price level. Assessments of the bank's diversification of economic risk is another aspect of our program of supervision in the context of the bank examination process.

Our task as regulators is to balance the banking system's observations and conclusions on individual countries with our own independent judgments; to assure through the examination process that portfolio diversification is a demonstrated practice; and to evaluate each bank's system for evaluating country risk.

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Risks involved in lending to any one country, or group of countries, are constantly changing. In addition to the economic factors, the stability of the political system, the potential for social unrest, and the external and internal management of the country's financial affairs are but a few of the concerns that must be evaluated when assessing the degree of risk in lending to borrowers in a foreign country.

As such, it is incumbent upon the banks to have an adequate system of evaluating country risk and further, that they review their country exposures frequently.

The OCC has taken active steps to assure the safe and sound practices of U.S. banks in overseas lending and from overseas locations. During calendar year 1979 the OCC conducted on-site examinations of 93 overseas branches, subsidiaries and affiliates of 26 nationally chartered banks. In addition, we have a permanent staff located in London that continually examines the activities of the 26 national banks with a presence in that market. For many of these banks, London is their largest overseas office. In addition, the London staff keeps the Washington office informed on the current environment in the overseas markets.

The Future Role of U.S. Banks in Recycling

Another aspect of our supervision of international lending is the periodic collection of data. Country risk trends and

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exposures within the banking system are monitored through a semi-annual report, initiated in June 1977. All commercial banks which have substantial foreign operations provide detailed information by individual country on their foreign credit extensions, including information on maturities, guarantees and customers.

The most recent available data on country risk exposure are as of June 30, 1979. At that time U.S. banks had an aggregate country risk exposure of $196 billion, virtually unchanged from the year-end 1978 total of $196.4 billion, but up about 12% from the June 1978 level. Roughly one-quarter of the June 1979 total, about $55 billion, consisted of claims on non-oil exporting LDC borrowers. Not all of this credit was extended to finance oil imports. Some financed other import activities as well as long term economic development projects.

To assess the future role of U.S. banks in lending to LDC's it is necessary to keep in mind that a banker's decision on a loan to an LDC shares essential characteristics with the decision on any other prospective loan: What level of risk attaches to the loan? Does the return on the loan compensate for that level of risk as well as yield an adequate profit? Can the capital of the bank support the level of risk involved? How does the loan fit into the bank's long term pattern of customer relationships?

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The question of risk concerns the willingness and ability of the borrower to repay. Countries in general, including LDC's, display a firm resolve to repay, since failure to do so would likely bar them from access to external capital for many years following a default or repudiation. However, the sensitivity and perception of banks with regard to political risk seems to be increasing.

The economies of several of the more prominent LDC borrowers have grown rapidly in the past decade. In addition their holdings of foreign currency reserves have swelled. These two factors presumably strengthen their ability to repay. A cloud on the horizon concerning their ability to repay, however, is the possibility of weak economic performance in the industrialized countries in the next few years. The LDC's are dependent upon exports in order to earn the foreign currency needed to service external debt. A serious economic slowdown in the industrialized countries would reduce the demand for LDC exports and hence adversely affect their ability to repay. The imposition of protectionist barriers to trade among the industrialized nations would have a similar adverse effect.

The likelihood of such outcomes cannot be estimated precisely. The marketplace implicitly forecasts future outcomes, as revealed in the loan terms it sets out, especially

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rate and maturity. In the Eurocurrency market, where most LDC borrowing takes place, rates are generally set in terms of a margin or "spread" over the London Interbank Offered Rate (LIBOR). When the perception of risk is greater, wider spreads are required to attract lenders. Maturity is another aspect of loan terms related to risk, with greater perceived risk generally requiring shorter terms to elicit lenders. Indeed, in 1977 and 1978 U.S. bank participation in the Eurocurrency market was rather restrained relative to 1975 and 1976, presumably because of a perception that loan terms were inadequate to compensate for the risks involved and yield a satisfactory profit. Additionally, during those years domestic loan demand was strong and yields were high. This was also a period of increased supervisory attention to the bank's management of their foreign portfolios.

There is some evidence of a tightening of terms in the Eurocurrency market in recent months. Salomon Brothers, for example, reported in February that "Loans carrying final maturities of 12 to 15 years are a rarity in today's market. In addition, commitment fees since last fall have risen by 1/8% to a prevailing level of 1/2-5/8%. In the final quarter of 1979, contractual lending spreads rose by approximately 1/8%, primarily for borrowers from non-oil developing countries. We envision another 1/8-1/4% increase in contractual spreads over

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the next few months, with a greater degree of differentiation between prime and non-prime borrowers. While the better regarded borrowers -- both commercial and sovereign -- will most likely continue to command comparatively low spreads, the burden of higher lending margins will probably fall most heavily on the non-oil producing nations."

Spreads may also widen because of the financial condition of the larger U.S. banks. The ten U.S. banks most active in international lending, for example, account for about 70% of the aggregate country risk exposure of the U.S. commercial banking system. Therefore, their requirements tend to set a tone in the marketplace. The rapid inflation-induced growth of assets of large U.S. banks in recent years has had the effect of reducing capital-to-asset ratios. For these ten U.S. banks, with aggregate year-end 1979 assets in excess of $500 billion, the composite capital ratio in the fourth quarter of 1979 was 3.6%, down from 4.0% on average in 1976. This decline in the capital ratios of major U.S. banks is likely to lead them to require more favorable terms in lending to LDC's in order to compensate them for deploying capital against additional risk assets. This effect will be heightened by the maturity transformation aspect of recycling.

At some point, however, increasing yields no longer attract lenders because they impair the borrower's ability to service

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the debt. However, banks which have already lent substantial amounts have an incentive to work with the borrowers in order to safeguard their existing loans.

The future course of worldwide inflation, world trade conditions and foreign exchange mechanisms are obviously interlinked with how much external debt the LDC's will be able to take on, at what rates, and with what necessary adjustments to assure repayment.

A tightening of lending terms will have a significant bearing on the willingness of individual bank managements to increase the present level of international lending. If profit margins widen, it is generally expected that some U.S. banks will significantly increase their international loan portfolio. Even if interest margins do widen, however, it is not likely that there will be a dramatic increase in the number of U.S. banks engaging in international lending. Most banks that were desirous of entering the offshore market have already done so. (Out of over 14,000 commercial banks in the U.S. only 128 report country risk exposure assets.) Those that have not entered the international market heretofore are not likely to be enticed merely by a temporary widening of profit margins. We, as bank regulators, neither encourage nor discourage U.S. banks to engage in international lending. That decision is the responsibility of bank management. We do, however, carefully

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evaluate whether the bank has the capacity and capability of assuming a role in international lending.

In summary, the role U.S. banks will play in future lending to LDC's will be jointly determined by the interplay of their own capital positions, the lending terms established in the Euromarkets relative to profit opportunities at home, the long term relationships between the banks and their LDC customers, prospective economic conditions in the LDC's and the industrialized countries, and perceptions of the political risk in lending to LDC's.

The Future Role of Foreign Banks in Recycling

The same financial and economic considerations which will affect the role of U.S. banks in future lending to LDC's will also affect the behavior of the major foreign banks. They will also be influenced by domestic conditions in their home country markets and by the attitudes of the central monetary and bank regulatory authorities in their home countries.

Whether major foreign banks provide under 50% of the bank credit to the LDC's, as they did in 1975, or over 90% as they did in 1978, or whether bank credit generally provides 57% of the external borrowing needs of the LDC's, as it did in 1975, or 68% as it did in 1979, cannot be predicted with great accuracy with the information available to the OCC, given the financial and economic uncertainties referred to above.

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Moreover, the ranges of bank credit generally and foreign bank credit specifically just cited represent historical experience but may not provide boundaries for the future.

Conclusion

In light of the current uncertainty surrounding future policy developments in OPEC, the LDC's, and the industrialized nations, the need for international coordination becomes all the more evident. Here the importance of the IMF's role, as forum and executor, is clear. It is desirable to have international financial institutions adequately endowed for the task of supplementing and complementing the private marketplace. We therefore support the proposed 50% increase in the IMF.

Chairman NEAL. Thank you, Mr. Odom. Of course, I am delighted to see that both of you support our efforts to expand our participation in the International Monetary Fund. And I note that you probably can't see the distant future any more clearly than can we.

You point to the difficulties that may lie ahead. I think we are all aware of those difficulties. In the meantime, I think it seems to a majority of the subcommittee that we should go ahead with the proposed quota increase in the IMF and monitor the situation as carefully as we can over the years and make adjustments as we go along.

We don't seem to know a better process. If you have any advice on a better process, share it with us, please.

I would like to yield at this time to Mr. AuCoin.

Mr. AUCOIN. I have no questions, Mr. Chairman.

Chairman NEAL. Mr. Cavanaugh?

Mr. CAVANAUGH. Thank you, Mr. Chairman.

I think the chairman has a good question. As I take it, you have made some suggestions. I, first of all, want to compliment both of you. I think that you bring to this subcommittee some extremely important information and commentary.

Mr. Odom, you opened your statement by saying that the dramatic oil price increase as initiated by OPEC in 1974 began a process of fundamental change in the world economic order.

But has the structures of the world economic system reacted to that new economic order, in your judgment, in an appropriate and adequate way to assure future stability in the international economic community?

From the rest of your testimony, you seem to indicate that they have not by the suggestions that you make for enhancing the recycling process from its current constraints of heavy dependence on major commercial banks of the United States and other indus-

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trialized countries, and a minor and diminishing role even with this quota increase of the international financial institutions.

You indicate that that structure is not going to be adequate to meet the recycling demands on the international system in the early 1980's.

Is that a correct understanding?

Mr. ODOM. Mr. Cavanaugh, I hope I did not give the impression that I was deemphasizing the role that I thought that international organizations such as the IMF could and can play in the kind of structural response that is needed in this kind of shock that the economic order has taken.

I have suggested, and we do suggest in our statement, some other intermediaries that might respond and also, as Governor Wallich did, the possibility—I would like to think that it was a probability, but I certainly would say the possibility—that the OPEC nations themselves might provide some direct financing or additional investment in the less developed countries.

In the near term I think that banks can certainly address and respond to this need. Over the long term, I certainly think that organizations, international organizations such as the International Monetary Fund and the leadership that it provides nations in adjusting to these kinds of changes that must be made in order that the economy will be able to adjust to them.

Mr. CAVANAUGH. Well, as I see it, the United States is in a very difficult position, as the system has evolved since 1974. We have allowed our major commercial banks to participate and to provide the mechanism for the major portion of the recycling process which has involved some risk, which I note Governor Wallich indicates, has not always been priced adequately for the risk involved.

And we now find that that risk is growing as the level of debt among the borrowing countries has increased and the demands have continued unabated; that is, OPEC oil price increases, and as the surpluses have continued to accumulate versus deficits.

This has placed a strain and a certain increasing risk on those private commercial banks.

At the same time, we have allowed the international financial institutions to diminish both in size of resources and in proportion to the world trade and debt recycling process that is occurring.

Therefore, diminishing their importance, their ability to maintain stability, and their ability to maintain a public policy order in the world arena.

Now we are caught, it seems, with some unpleasant political consequences and if we take your suggestion of saying OPEC should directly lend rather than participate in an expanded basis in international institutions, funding and contributing on the basis of the surpluses that they accumulate, if they are allowed to do it directly, don't they then accumulate a tremendous political influence that destabilizes our political role in the world, as well as extends to them great leverage in terms of the economic makeup of the world that we might as Nation find undesirable?

That seems a very precarious alternative for us, as precarious as allowing the current system to continue where we imperil the stability of our commercial institutions.

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It seems to me that the structural change that is needed is to vastly restructure and redesign the international institutions to force contributions on the basis of surplus or relative to the relative surplus in deficit situation, but not to go off now and say, neither a second tier of U.S. banks should participate to spread the risk, bring in, as in your suggestion here, of bringing in pension funds.

I have to, quite frankly, say that's terrifying. I don't think that the pension fund managers of this country are in any way capable of evaluating the kind of risk that they would be involving their contributors in by now entering this mire of international lending.

But I understand where you come at it from, that the international monetary structure isn't adequate for the disruptions that occurred and continue from 1973–74.

But why can't we as a nation, the leading nation in the world, propound the leadership that says, we must redesign these international institutions to accommodate this new reality?

Why are we so reluctant to exert that kind of leadership? And I have been asking that question for the 3 years that I have served here. Why can't we say to OPEC, you have disrupted the world's economy. You must participate in a new structure that stabilizes and restabilizes the world economy based upon some realistic economic principles.

Chairman NEAL. Before you answer, we have been notified by the bells that there is a recorded vote occurring on the floor of the House.

So the subcommittee will recess for about 10 minutes in order that we might answer that vote.

[Brief recess.]

Chairman NEAL. The subcommittee will again come to order.

When we recessed, Mr. Cavanaugh had asked a little simple question requiring a yes or no answer. So I guess someone ought to give an answer. Was your question directed to Mr. Odom?

Mr. CAVANAUGH. Well, I would like to have both comment on it. I think that the Fed has done far more in terms of providing some leadership and perspective, and that it is more appropriately their role, although Mr. Odom's testimony was provocative on this matter by raising alternatives such as involving pension funds. I think that it goes to the essence of the structural instability that exists and we need to focus on that from both perspectives. So I might direct it first to Governor Wallich, who I know has given substantial thought to the issues raised in my question.

Governor WALLICH. Congressman Cavanaugh, the problems you raised are very real and I don't think they have a single answer. I do think they have a answer that can be put together from a number of pieces and components. One element is the strengthening of our international institutions, such as the IMF.

The World Bank is now starting on a program of structural adjustment loans. These are loans that are somewhat longer than the typical IMF loan, but they are designed to help the country readjust rather than just give it money to invest and grow.

I see banks continuing to play a substantial role. I see some adjustment too, by countries that have been heavy borrowers to have deficits no larger than they can finance. They undoubtedly

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can finance some deficits. The more solid the domestic policy they run, and the more they can finance, the less they will need. So these two things come together.

But when I say that some developing countries will have to invest more than they did the last time around, that means, of course, that the deficits that they don't have will wander someplace else. Unless we reduce our total consumption of oil in the world and thereby reduce the OPEC surplus, the deficits that the developing countries may not have will come to us. That means we will export less to the developing countries.

Developed countries are in a better financial position to handle these deficits if the deficits do not become large. The U.S. deficit was too large at one point and the dollar felt it. But the OPEC money has to go somewhere. It has to be invested; therefore, countries with large financial markets; sound currencies and sound assets can expect to get a certain automatic inflow of OPEC funds that provide a financing of their deficit.

That is why I think an answer can be found to the OPEC surplus problem if it doesn't get too large. But it probably isn't going to be found entirely in LDC financing, whatever the form.

I also share your view very much that ways should be found to bring OPEC into the financing picture. They have been in the financing picture through the IMF, of course. I would hope that direct channels could be opened up. There are considerable direct channels—mostly with other Moslem countries—both aid and other forms. I think more can be done here, and it is perhaps a question of whether developing countries can develop attractive assets from the point of view of OPEC assets, where the risks that undoubtedly exist are properly compensated by a risk premium and where the depreciation risk is covered.

Mr. CAVANAUGH. Just if I might have you comment on Mr. Odom's suggestion, though. Don't you think that it makes eminently greater sense to construct an international economic system in which the IMF and the international institution plays the dominant role in the financing of deficits and in making the monetary adjustments necessary? And don't you agree that even with this quota increase, leaving the IMF with total resources of less than 4 percent of the world trade figure, is woefully inadequate for that purpose? And the alternative of spreading the recycling process to a second tier of banks or to U.S. pension funds is a rather inadequate, I would say terribly inadequate, substitute to some substantial structural change in the international monetary system?

Governor WALLICH. The deficits of the LDCs, not to speak of the other countries for 1980, are estimated in the range of $50 to $60 billion. That would completely exhaust the usable currencies of the IMF. Moreover, since there is no expectation that that can be repaid in the short run, it can only be invested productively and made to generate output from which the debt can be serviced.

The IMF just couldn't cope with that. The World Bank does the kind of lending—long-term lending—that increases the growth of these countries; and bank lending does the same. At least that is how it ought to be.

The banks have done roughly one-half—depending upon how one counts it—of the recycling, with the rest coming from official and

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private long-term flows. It is very difficult to see how one is going to replace that large infusion and transfer the job to international institutions.

Mr. ODOM. I would comment on Mr. Cavanaugh's remarks with respect to our comments about insurance companies and pension funds. I certainly recognize the restraints that you are talking about. We were simply trying to identify some way by which we could explore some alternatives to bring about some kind of a balance between the liability and the assets side in the financing of relatively long-term assets with short-term liabilities. And obviously there are constraints, and management is one of them. There are ways by which those constraints can be addressed.

Mr. CAVANAUGH. I know that my time has expired, and I just briefly want to say that I am disappointed with both of your answers, to the extent that you seem to be saying that because the current system is inadequate we should leave it inadequate, spread the future risk throughout further structures of our own domestic economic system, to banks, to another tier of banks less sophisticated in international lending, to pension funds and to insurance companies, because we are afraid to confront OPEC and we are afraid to project to the world the structure for a new international economic order that is necessitated by the actions that OPEC has taken since 1974.

I think that is a terribly poor answer to that international economic disruption. It is sad.

Chairman NEAL. Mr. Leach?

Mr. LEACH. Governor Wallich, you say in your testimony that the rising cost of petroleum is the most critical issue in international finance. Might one say that secondarily to the high cost of current petroleum production is the Fed policy of producing a higher cost for former production? And I say this because when you have a high interest rate policy, some are winners and many are losers. The losers are those in the borrowing intensive sectors of the economy—housing, farming, whatever—and the winners are those with a lot of capital.

By having a high interest rate policy, you are providing a greater return to the OPEC surplus nations. You are also inplementing a policy that causes equity values to go down as interest rates go up, evidenced by a decrease in farmland prices over the past month and the drop in the stock market. And so, essentially speaking, you are putting a "For Sale" sign in front of the New York Stock Exchange and giving greater returns on the former oil production of OPEC countries.

Has the Fed done any surveys on the cost of a high interest rate policy as it relates directly to the new ability of the OPEC countries to earn more on the money they currently possess, as well as greater bargains available to them in making equity investments in the United States?

Governor WALLICH. I might point out that present interest rates are, unfortunately, broadly similar to the rate of inflation. If you take interest rates after taxes, they are not even positive in real terms. But that doesn't apply to OPEC. OPEC, of course, does not pay taxes, so they get interest before tax.

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OPEC nevertheless argues that they have not received the positive real rate of return. I would not be able to give you numbers on this. I did observe that developing countries paying the interest rates reflecting LIBOR in London have had a negative real interest rate over a period of time. That is, the inflation worldwide has been more than the interest they have paid.

Mr. LEACH. I would acknowledge that in previous years, but would you assess that to be the case in 1980?

Governor WALLICH. It is a very varied experience. The borrower who is in a high tax bracket, whether a corporation or an individual, probably still does not have a positive real rate. The borrower who for some reason can't deduct the interest is paying a very heavy interest burden. It is one of the terrible results of inflation that the impact of interest rates begins to differ with individual situations.

Mr. LEACH. I appreciate that. I do have several more questions.

Chairman NEAL. Mr. Cavanaugh is going to chair the subcommittee while we go vote.

Mr. CAVANAUGH [presiding]. One of the luxuries of not running for reelection is you are released from the bondage of procedural votes.

Governor Wallich, do you think that this quota increase is going to be adequate to meet the adjustment demands of the deficit countries over the next 3 years? The U.S. contribution being $5.4 billion, and I believe will increase the aggregate resources of the IMF to some $58 billion from the current level of $36 billion. Is that going to be an adequate amount of resources to maintain stability?

Governor WALLICH. I think it is adequate. But it bears watching because the rate of inflation has been higher than we anticipated. Therefore, relationships of IMF quotas as compared to the level of world trade might not be as predictive.

One has to bear in mind that when the IMF was set up the ratio of quotas to trade was quite different. Quotas were much higher. On the other hand, lending was largely limited to each country's quota—the amount that they could borrow. Today we have got a number of special facilities—the extended facility, the compensatory facility, the supplementary facility, the oil facility, and the buffer stock financing mechanism. When you add these things all up, I believe a country can draw as much as 465 percent of its quota under certain special circumstances.

So in terms of what a single country can get, the relative decline in Fund resources is compensated. One might raise the question, "What if a lot of countries come in for something like not exactly 465 percent, but still a large chunk?" Because the volume of usable currencies is, of course, nowhere near the total of quotas.

Mr. CAVANAUGH. And what would happen is they would break the bank.

Governor WALLICH. The bank would have to defend itself.

Mr. CAVANAUGH. Well, if you are predicting a lessening of the role of the U.S. commercial banks, an increase in the surpluses, greater caution among the European and Japanese banks, which I take to mean a lessening, and resources within the IMF that are, even with what you are saying, diminishing in terms of relation-

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ship to both world trade and the surplus deficit in equities, doesn't something have to give there? And what is going to give?

Governor WALLICH. I would say that one should have elasticity to increase the supply. But I am not sure that one would want to start with very large supplies of money, because that encourages cupidity and discourages adjustment. I think a certain sense of limitation of resources would have a wholesome effect, both on the policies of lenders and borrowers. But I agree with you that if situations arise where there is demonstrated inadequacy, then new action would have to be taken.

That action could be taken, for instance, in the form of an increase in IMF borrowing. As you know, the IMF has borrowed before. It could borrow again and it could borrow from members. It could conceivably borrow from the open market. We are not up against a fixed wall.

Mr. CAVANAUGH. Do you foresee, as Mr. Rockefeller apparently does in his statement—I don't have the date. I have the statement here. But he said that next year he would anticipate the need, because of the lessening role of U.S. banks, for an additional increase in the Witteveen facility.

Can you foresee that, or do you think that he is incorrect that the need will come that soon?

Governor WALLICH. I think that one cannot foresee that with any assurance. There are many reasons for thinking that the OPEC surplus will not diminish anywhere nearly as rapidly as it did the last time around. On the other hand, we had a recent statement by Minister Yamani in which he said OPEC absorptive capacity was being underrated.

I think one would have to see how this develops. The demand for the Fund's resources again depends on the position of not only the LDC's. What has given the Fund its great liquidity is the improvement in the position of several countries that have been borrowers. Meanwhile, we have had at the level of the larger countries a very welcome convergence of financial positions. The big surplus countries have come into moderate deficit, whereas the United States has worked out of a large deficit. And all of that, I think, improves the prospective position of the IMF.

Mr. CAVANAUGH. Governor Wallich, in your January 24 statement you said broader participation in LDC lending by a larger number of banks would help to make more flexible the supply of bank loans for LDC's. The reduction in the share of U.S. banks in this lending accompanied by a strong expansion, at least until recently, by banks of many other countries, represents one such form of diversification. However, within the confines of U.S. banks there has been no broadening of participation in foreign lending generally.

Would you think that it would be healthy to expand the participation in foreign lending among U.S. banks and to involve, as some have suggested, a second tier of banks in the financing of the new and larger LDC deficits?

Governor WALLICH. I would agree with Mr. Odom. Naturally, I have in mind that the banks do their homework and study the loans, and that they cover their risks by an adequate spread. In those conditions, it sums that a bank that operates conservatively

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and tries to know what it is doing, would benefit itself and its depositors and stockholders.

But I would like to yield to Mr. Odom.

Mr. CAVANAUGH. So you do advocate expanded lending by a second tier of U.S. banks?

Governor WALLICH. Subject to proper precautions and supervision of the regulators.

Mr. CAVANAUGH. And one of the reasons for that necessity is that the major banks are running up against, in some instances, their prudent limits in relation to capital; is that a justification for broadening the participation to other banks?

Governor WALLICH. That is one way in which these things happen. A few banks do it first. If it turns out to be good business, one would expect that other banks would want to participate. Some have pioneered and I don't see anything negative in participating in a business that is sound. If it isn't sound, then none of the banks should be in it.

Mr. CAVANAUGH. Well, let me reflect on what I think is somewhat negative here. We have Mr. Rockefeller on February 27 speaking about merely the growing instability resulting from the higher debt burdens now being borne by oil importing LDC's, and the fact that the risk is now increasing. We have the major U.S. commercial banks, who have supplied the capital that has resulted in this expansion of debt, necessarily so because someone had to do the recycling and we didn't create an international structure by which to do it, and so the ad hoc system of recycing through major U.S. commercial banks evolved.

But now we find ourselves exactly where most everyone predicted that we would be, with these debts accumulating, becoming a larger and increasingly unmanageable proportion of LDC country obligations, some of them up to 30 or 40 percent of their GNP; is that correct?

Governor WALLICH. These figures relate to exports in some cases. I doubt that it is GNP, but I have not got all of the numbers.

Mr. CAVANAUGH. But some very dangerous situations. And now, rather than going to OPEC, who continues to amass the surpluses—and you know, you have made some excellent suggestions and some excellent criticisms, but I find them somewhat absent or muted today.

You have said that the current system encourages higher oil prices, because the OPEC countries don't suffer the risk of their lending, don't feel the risk of their lending, are free to continue to escalate prices without concern for the consequences, because the major banks have acted as intermediaries and absorbed that risk for them.

But now you come before us today and you are advocating not addressing that problem, but spreading the risk among another tier of U.S. banks, broadening it to insurance companies and pension funds. And that just seems that you have made a sudden, dramatic, and very dangerous reversal.

Governor WALLICH. That certainly wasn't my intention. As I said, I think that the solution has to be put together out of a number of components. It is not going to be the banks alone, the IMF alone, or OPEC alone.

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And I am at fault perhaps for not addressing more the role that OPEC can play.

OPEC necessarily will finance their surpluses because they have to invest their surplus somewhere. They can only invest it in the world outside of OPEC. If they invested it at home, they would be importing and the surplus would not exist.

So undoubtedly, OPEC could make contributions via the IMF and the World Bank by direct lending; that is the channel which you have stressed. Or they make contributions in the way they have so far, by putting their money as safely as they can into Euromarkets banks.

Their attitude, as far as I understand it, is that they are running considerable risks in bringing their oil above-ground, accepting paper assets in return for it, and that the residual risk—the commercial risk as it were—of investing that money should be borne by somebody else.

It would seem that this is a question of price and risk premium—that at some risk premium, it would become attractive for OPEC to make direct loans and that that line should be very much pursued.

I agree with you, Congressman. The immediate effect of that, however, might not be large enough to make a real dent in the problem and we should still be left with the need to finance a very large amount of deficits that would not be financed directly by OPEC.

Mr. CAVANAUGH. Thank you.

Chairman NEAL [presiding]. Mr. Leach?

Mr. LEACH. I would like to briefly go off on a slightly different tangent, but one that relates to this discussion.

Governor Wallich, has the Fed or other central banks ever entered the silver market to bolster prices?

Governor WALLICH. No, we have not.

Mr. LEACH. It strikes me that commodity speculation reflects, to some degree, instabiltiy in the international economic structure and more specifically on instability in foreign exchange markets. It seems to me that as governmental policy, we ought to be doing as much as possible to discourage speculation at this time: for example, tightening U.S. laws with regard to how much of a given commodity any individual can control and, at the same time, moving internationally to negotiate an assurance that similar restrictions exist in other principal markets.

Beyond that, we ought to be doing everthing within our power to prompt other governments to discourage their official entities, as well as private citizens, from speculating dramatically on the commodities exchanges.

Do you think that realistic? Would you think that there is no relationship to the international banking system, or that there is a serious relationship?

Governor WALLICH. The Federal Reserve's credit restraint program addresses that point; that is, among the types of loans that the Federal Reserve takes a dim view of are speculative loans, as well as take-over loans that don't have an adequate productivity fall-out.

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So the use of credit for speculation, particularly at a time when credit is excessive, is very undesirable and we are tiaking a stand against that.

One generally tends to notice speculation when something very dramatic and bad happens. But one has to think of the many useful functions that speculation performs. If somebody owns a large amount of silver, and doesn't want to run the risk of carrying that inventory, he will not sell the siver itself, but will sell silver futures or forward short against the silver he has.

Now he has to find a buyer. That buyer necessarily has got to be a speculator, unless he has a trade interest or owns such futures. And so speculation does perform a useful function.

Mr. LEACH. That is understood. But, there is an important distinction between hedging and speculating, and often that is blurred. What we have seen in the last few weeks would appear to be pure speculation rather than commercial hedging.

I commend the Fed for what you are doing with regard to banks. However, you don't have similar authority with regard to brokerage institutions. I wonder if you are advising on whether the CFTC and SEC should have greater power and should be coming up with new rules and regulations with regard to speculation? Also, are you advising through intergovernmental channels foreign central banks?

Governor WALLICH. I would expect that these questions will be raised and looked at. I have to confess that my bias is to minimize regulation. We administer such a vast amount of regulations that the thought of adding to it internationally does not gladden the heart.

I think that there is concern everywhere that speculation that gets out of hand can be very destabilizing. There is not a great deal that can be done to prevent that. As you pointed out, there are many channels and the business can just go to some other place.

The fundamental answer is to run economic policies that will neither cause people to doubt the value of their money nor give people a justification for such ventures.

Mr. LEACH. I appreciate that and I have one more question. But if you will excuse me, I do have to go and vote.

Mr. CAVANAUGH [presiding]. You seem to indicate that the risk exposure problems and concentration of loans among the major foreign lenders has diminished.

Is that true? Have you experienced less, for example, citations, comments in your examination process over the last year than, say, in 1978?

Mr. ODOM. Mr. Cavanaugh, I will be glad to ask Robert Bench, who is our Assistant Chief National Bank Examiner, who is responsible for the examination of banks in this area. He might want to respond specifically to that.

I don't know whether he has any comments.

Mr. CAVANAUGH. Fine. Do you want to give your full name and position for the record?

Mr. BENCH. My name is Robert Bench, Assistant Chief National Bank Examiner, Comptroller of the Currency.

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Mr. CAVANAUGH. Mr. Bench, is the number of comments that your examiners are issuing declining in terms of foreign country loans, or increasing from 1978 through 1979?

Mr. BENCH. Let me answer that in two ways. The examiners' comments that deal with criticisms of particular foreign loans has decreased in their examination reports.

However, the examiners' comments discussing international lending and the broad category of international lending and the international credit administration process in banks has dramatically increased. It has increased because, as Mr. Odom and Governor Wallich indicated, the agencies have changed their system of looking at the manner in which banks lend overseas.

This new system encompasses a great deal more countries, a great deal more types of loans, so that we feel that we have strengthened the examination process as regards international lending. We have stengthened it and the result of that strengthening has been increased comments in the reports as to what the bank does and how it goes about doing it.

The result of that has been less criticism as we get to understand better the exposures that are out there.

Mr. CAVANAUGH. Well, I understand that and I certainly realized when I came to the Congress 3 years ago, I think, that the regulators were in very immature state of the country risk evaluation and I think that you have made really great progress in that and it is a relatively new art to any substantial degree and I can appreciate that. But your overall judgment, then, is that in terms of particular banks being burdened with high risk exposure is less than it was 2 years ago, or more, or unchanged?

Mr. BENCH. I think that we are comfortable with the level of risk that is presently on the books of the U.S. banks, primarily because we feel the banks have strengthened the manner in which they manage that risk, that is, we see better diversification in loan maturities, we see better diversification by the types of loans the banks make within an exposure.

We have seen a real strengthening in the way banks have analyzed their own country exposures, how they set their limits, how they go about analyzing country risks.

We have seen a good strengthening in the way banks report their risk to their boards of directors and in the interaction among the executive management of the bank with the lending officers.

So that while the numbers, per se, have increased, our perception of the risk is that the risk is less because of the way the bank manages it.

Mr. CAVANAUGH. But the countries are not in worse shape?

Mr. BENCH. That is right. But that is also not to say what Governor Wallich and Mr. Odom said earlier. That is, at some point in time, we can see that the general levels of exposure vis-a-vis capital funds in these banks will be or could be a supervisory concern from a diversification standpoint.

Mr. CAVANAUGH. Well, that is what bothers me about your suggestion that we ought to spread the risk to more banks because I think your borrowers are deteriorating in their ability. The lender banks say that; and yet, I hear the regulators saying here today

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that we have got some—we have got a lot of borrowers out there who are really pretty well borrowed up.

And on top of their heavy debt situation now to roll over and to renegotiate their existing debt circumstance is going to entail substantially higher cost to them, as the cost of money has risen, and that the answer to that is to bring in more banks, insurance companies, and U.S. pension funds because they are not as heavily exposed in their portfolios. Because you have got a certain portfolio protection, because you have not got any real bad loans out, it does not seem to me to make sense to say, well, we have got some other banks who have had some very bad borrowers. Let us move them around to some of these people who don't have bad borrowers.

Mr. ODOM. Mr. Cavanaugh, I think what we tried to do in our statement was to reflect the reality of the situation. I don't think that we suggested that there would be an increase in the number of institutions.

I think I pointed out there may be an increase in the extent of bank financing, but that there probably would not be an increase in the number of banks, particularly of the regional banks. While regional banks have participated in the past, even to a greater extent than they have now—they are still in the market. And there is a likelihood that they, those that are in the business now, might increase their outstandings.

I don't think that it is our view that there will be new banks coming into that market.

So I don't know whether—certainly we didn't want to give the impression that we thought there would be a net increase in the number of banks participating in this recycling.

Mr. CAVANAUGH. You don't think new banks should participate in the recycling?

Mr. ODOM. I am trying to suggest to you what we anticipate will happen, Mr. Cavanaugh?

Mr. CAVANAUGH. But I though that you were advocating that they should. Is that wrong, Governor Wallich? Did I misunderstand you?

Governor WALLICH. I really don't advocate anything to the banks. They have to make the judgments and they are quite qualified. If they were not qualified, they certainly should not get into that business.

Mr. CAVANAUGH. But you are saying that a need exists for new lenders.

Governor WALLICH. That need can be met in other ways. Here is a business opportunity and they should regard it in terms of their business judgment. If it is good for them, their customers, their depositors, and their stockholders, fine. But it is not that they are being urged to take on some kind of a burden that one wouldn't know where to go otherwise.

Mr. ODOM. Mr. Cavanaugh, I think that it is important to stress, and that is that it is not our—we have not identified our role as being one that we should encourage or discourage banks to enter or to abstain from a particular market. Now we do encourage them to assess, to understand the risks, to assess those risks and to try to take those risks into account in their underwriting policies.

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Mr. CAVANAUGH. I understand that your role is not to advocate any line of business that your regulated industries would become involved in. But when you are discussing a broader macropolicy and how this recycling process is about to come about, you do have to deal in appropriate kinds of expectations, which I think that you did.

And my understanding was that you were expecting other banks, and I think that that would be and I thought in a benevolent sort of way, realizing that there are a lot of seriously troubled borrowers out there.

It troubles me that the regulators wouldn't be disturbed that a consequence might be because of an inadequacy of any alternative that the big banks would be looking to share some of this business with smaller banks.

I have just one brief question on the Eurocurrency thing. It is just a curiosity more than anything else. But several years ago there was a story on the role of Citibank in the Eurocurrency markets. And an individual, David Edwards, who received some notoriety at the time, and it was my understanding that the Comptroller then was doing an investigation of manipulations in Eurocurrency markets by banks. But I have not recently heard any resolution of that.

Was it ever concluded? Was the *Edwards* case ever finalized?

Mr. ODOM. It is still in process, Mr. Cavanaugh. I can't comment any further. I don't think it would be appropriate to comment any further.

Mr. CAVANAUGH. Other than that the case has not concluded?

Mr. ODOM. That is correct. It has not been resolved.

Mr. CAVANAUGH. Thank you, Mr. Chairman.

Chairman NEAL. Why don't you proceed?

Mr. CAVANAUGH. Are you noticing any change in policy that the major commercial banks are now adopting toward country lending in terms of lessening their role?

Have they made a conscious decision to diminish their lending role?

Mr. ODOM. I think, as I stated, as I said in my statement, there is a heightened perception, I would think, of the political risks attendant. We would like to think that banks continue to look carefully at the transfer risks, at the political risks, at all risks involved in country exposure and weigh those risks against the profit that they are going to get from it.

I can't say that there is any lessening in their tendency to, after taking those risks into consideration, to make credit available where they think that the risk is worth taking.

Governor WALLICH. My impression is that this is a matter of judgment. When I have talked to bankers, their attitude seems to be substantially different. Some say that they are quite low in international lending and plan to expand. Some say that they feel they have about done enough.

And on the whole, American banks, as I have said, have pulled back over the last 2 years in the face of inadequate compensation.

What they will do if compensation becomes adequate depends partly on what alternative opportunities they have and partly on

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their capital position—whether they are able to handle the expansion.

I think that this is a situation of considerable flexibility, so that one isn't looking at impasses in the near future, where something that needs to be done could not be financed in some way.

The great problems are down the road.

Mr. CAVANAUGH. Well, I agree and we should end up here and let go, and I will turn it back over to the chairman.

But I think, again, just one final comment, is that what we are doing here with this legislation in the absence of doing anything else is assuring that the problems that we will have down the road are going to be greater.

And as I read and understand your testimony here today, you are really attesting to that. You are saying that the system has great structural deficiencies.

But I find that the suggestions that you have offered us today are woefully inadequate and even dangerous.

What I see happening here is the absence of an international structure that is sound and related to the realities that exist in the world today in terms of the OPEC surpluses, is that we have left ourselves vulnerable to exactly what is happening.

We have to be concerned about the stability and the soundness of any given financial institution in this country.

And so, when the borrowers become overly burdened with debt, as they are now, as a result of their having to pay these oil bills, the lenders, the commercial banks, must become prudent and, therefore, force a reduction of the credit available while the demand is not diminished because the oil bills have gone higher, the needs of those countries to continue to finance both their trade and their development increases. And yet, we have been reluctant, sadly and woefully reluctant, to redirect and force a redirection to those OPEC surpluses into the international monetary and developmental system in order that they could be apportioned out as the adjustment process would require, and that inadequacy of resources creates the next problem, which is a requirement on the IMF to impose extremely harsh conditions because of the inadequacy of their resources.

They don't have any choice but to go into a country and say you must depreciate, you must drastically reduce your public spending. You must drastically reduce your imports, therefore creating all of the social and economic instability that is attendant to that kind of accelerated adjustment within any economic system.

So we have created, I think, the seeds for rather severe international political and social and economic upheaval. And the answer to it cannot be to expect any tier of U.S. banks or the teachers' pension fund to recycle these OPEC surpluses.

I am willing to go along with this increase. But we should certainly use this opportunity—you and the bank regulatory agencies—and I think, really, you know and understand the problem in the same context that I do, and those in the executive branch I think have to begin to paint for the people of this country and for the international community an economic program that is reasonably related to the realities of the world in which we live. And

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unless we use this opportunity in this legislation, we may not have another constructive chance to begin this process.

I think the world community is ready to respond. I think that they understand that the level of public resources, the contributions to those resources by OPEC, has to be dramatically increased. If the commercial banks are to be preserved and if the international trade system is to be preserved and if we are to preserve any kind of social and political stability in the world, we have to have a system capable of recycling, capable of adjusting, capable of making developmental contributions and financing relevant to the huge disruptions that we have experienced since 1973-74.

And I think that we can all do much better than we have in terms of designing the theory by which the world can react. That is the obligation of this country, and we are not meeting that obligation, as I see it. And I think that time is running out for us to do it. I think we know what is right, for some reason. And Peter Peterson, who was here a week ago with Katherine Graham, says for some reason we lack the political will. I don't know why that is, but I think that that is not irreversible; that we can acquire it.

Mr. ODOM. Mr. Cavanaugh, what we have tried to do is to recognize one reality, and that is that the banks have carried a burden of—carried the burden, the major part of it—of recycling this debt. We have tried to identify some alternatives that might be available. We certainly will continue to look for them.

Among those alternatives that we identified certainly were international organizations, and this obviously is the one that you would stress and you would stress that we do everything we could to encourage OPEC's participation through international organizations.

Certainly, we all share the same objective. We don't want to see the banks continue to carry this burden over the long term. We think it will cause serious supervisory—it will give us serious supervisory concerns if the banks are required to do so. And so we all need to be looking for alternatives.

Alternatives, we mentioned; insurance companies and pension funds. And, as I have said, we recognize the constraints, the management constraints, with respect to those alternatives. But I will certainly assure you that we will continue to lend what weight our voice has to try to identify such alternatives as may be feasible to work out of a problem that I would certainly agree with you, certainly in the intermediate term if not the long term, could become a very severe and critical one.

Mr. CAVANAUGH. Thank you.

Thank you, Mr. Chairman.

Chairman NEAL. On that point, if I can, I come to a different conclusion than my friend from Nebraska, Mr. Cavanaugh. And I would like to get his attention, if I can, just for a minute, because it seems to me what I hear him saying is that we are not doing enough. And I would agree with him that we are not doing enough. But it seems to me that we are probably doing, in this time of obvious public concern for restraint in Government and reduced governmental expenditures, we are doing all we can I think that the administration has taken the lead in really a very courageous way.

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The President has recommended big increases in our bilateral and multilateral aid programs. And it is the administration that presented this legislation to us to increase our participation in the International Monetary Fund. I guess you could fault them for not urging that we do more at this time. But frankly, it seems the legislation granting increases in our aid program appears to be in great difficulty, as it is. I don't have a good reading on the IMF legislation at this point. I think if we are able to get this bill passed by our committees and the Congress.

But it just doesn't, to me—frankly, my reaction is that you are correct in defining the problem, but that there are probably a number of other things that we could say. Why don't we exert some stronger influence on OPEC to bring down the price of oil? You say we are not doing enough in that direction. I would agree.

It is not, though, it seems to me, from a lack of political will, as the gentleman suggests; it is because we don't know what to do. And Mr. Peterson, when he came before us, had an idea: He wanted to tax everyone in the world. Well, he wanted the political will for us to impose taxes on ourselves and the rest of the world. Well, that, to me, frankly, is just a totally unrealistic proposal. It is not a proposal of courage and will; it is just unrealistic and it is not going anywhere.

So, if the idea of courage or wisdom is to propose things that have no chance of gaining a political consensus, then I simply would not have much sympathy for that approach.

I think the gentleman has made a valuable contribution in pointing to the seriousness of these problems. I think there is no doubt about their seriousness. But I simply can't agree with him that the administration is not trying to offer some leadership in this area—because I think clearly they are—or that we are not doing enough at this time.

It is my observation that we are probably doing as much as we can do at this time, not that we should think for a moment that by passing this legislation that we have solved all of the world's problems for any years to come. We certainly will not have. But it does seem to me that it is a very necessary first step and that we certainly should continue to monitor it in the future. And I don't think that it is correct to think that we will give up on opportunities for future monitoring if we should pass this legislation now. We will not. We can hold hearings again next week if we need to, or next month or whenever necessary. And it may be.

I don't remember anyone commenting on it, but I would not at all be surprised if there were not a need for another supplementary facility in the IMF, much as the Witteveen facility that passed a couple of years ago. That may be necessary. That may be another approach. And it may be that we can find ways to get OPEC to reinvest in developing countries and lend directly to developing countries. We haven't found it yet.

I think we should keep trying, and I would just hope that we would have the gentleman's full support in taking this modest but very important first step.

Mr. CAVANAUGH. A couple of comments. First of all, I am deeply indebted to the chairman for all of the patience that you have extended to me throughout these hearings. And we have tended to

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move, I think, closer together in our views of certain things. We still have some, perhaps, misunderstandings of definition.

First of all, I don't view the IMF at all as a foreign-aid obligation. We are not contributing to the development of foreign countries; it is not a giveaway program. And it is an international monetary adjustment process by which we maintain stability, economic stability, in the world community. So what we contribute isn't part of foreign aid and foreign assistance. And I don't think that it is productive to confuse those and to say that our $5 billion here is certainly an indication of our shouldering our burden—because it isn't our burden, it is a part of the international responsibility to keep monetary order and to provide the mechanism by which adjustments can be made when there are disruptions in that order. And we are fully meeting our burden, I would speculate, given the nature of the international monetary activity, but OPEC is not.

And we have designed a system, we have advocated a system, we have sustained a system in which they are not expected to and which Governor Wallich and many others have said encourages irresponsibility in pricing. And this proposal before us again ratifies and perpetuates that system.

It in no way says to OPEC, Look, as a result of your new pricing mechanism in 1973-74—and there are strong arguments for the reasons you can make those on the basis of your resources and your economic future—but the fact of the matter is that the world that you live in, as a result of your actions, has been greatly disrupted. And we used to have an order, system in which order was maintained and was held together by a coherency of international monetary policy with international economic reality. We don't have that any more because of the disruption that your pricing policies have brought to that order. You must, if you are going to share the real benefits, begin to participate on a realistic basis in the adjustment process that is necessary in order to maintain stability in the world.

And we simply haven't done that. We have continued to say, even though we know it is wrong—Dr. Arthur Burns, in 1976, said, "When OPEC increased the prices, they declared economic warfare on the Western World." And we didn't respond, and we haven't responded since then.

We abdicated it to a process that has functioned but hasn't worked, the recycling through our major banks. And when we pass this legislation, we will be again be saying, We are going to ratify and continue and perpetuate that process even though we know it doesn't work, even though we know that someday the burdens and the tensions that will be created and the structural imperfections that will be aggravated will force a substantial disruption. We know that, and we should be honest and candid with ourselves as we continue this process.

And I would be perfectly satisfied, and you know that I will vote for this legislation because I don't have any choice, but I would be satisfied if the leadership of this Nation at least would talk about it, at least would indicate that they are willing to exert the leadership. But, unfortunately, we don't. And how can we expect OPEC

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to respond, how can we expect them to be responsible, unless we tell them that they are not. And that is what we are not doing.

And, Mr. Chairman, you would not hear a word out of me, you would not see an amendment and I don't think there should be any, if we could evoke that kind of appropriate leadership responsibility. That is all that I am asking for. That is the role that we should be playing. It is a role that we haven't been playing.

And the consequences of it are atrocious economically, socially, and politically. And we are forcing, I think, these poor countries of the world to look at us as a country with the policy of supporting OPEC and the major banks, whose immediate goal has been to protect their interests and to make money off of it. And the fact is we ought to have a broader public policy that we can go to the other nations of the world with, and we don't. We are, in fact, exactly what they say we are: Gratifiers, supporters, and endorsers of the pricing and profit system of OPEC and the major banks. And that system is seriously impaired, and we will pay the consequences for it.

Chairman NEAL. Let me say I again agree about the seriousness of the problem. And I also agree that we have simply not faced up to our dependence on—terrible dependence—on OPEC-imported oil, and the implications of that for our own economic and military security; I hope that we can deal seriously with the legislation I have introduced which would make us face up to that, which would make us unilaterally cut our imports and live with a shortfall, which we could do without either price or coupon rationing.

But that is another subject, and we will have to spend some more time on it another time. I have taken too much of Mr. Leach's time, and I would like to yield to him at this time.

Mr. LEACH. I thank the chairman. I don't want to enter this dialog, but would say, as an aside, that it is clear not only the United States but also the Western World does not have the will to stand up to OPEC. Perhaps that is not surprising.

What is surprising is that there appears to be a lack of ideas about how to take a stand if in fact we wanted to do so. It is amazing to me that in this administration there is no place that I know of and no individuals that I know of actually strategizing about how to deal with oil pricing and supply. In fact, if you look at the budget message which came up yesterday, one of the areas the administration has decided to cut back is development of the strategic petroleum reserve. That does not demonstrate to me a willingness to take the OPEC issue head on.

Speaking on behalf of the minority I would recommend to Congressman Cavanaugh's reading a set of bills introduced that are designed to break the back of OPEC. I would hope you might look at those, and I would be happy to pass them on to you.

Getting back to the issue at hand, given the fact that we are dealing with a situation none of us likes and given that the banks may have reached some sort of prudent lending limit and the IMF itself is limited, has any consideration been given, Governor Wallich, to new programs within the IMF to leverage use of their funds? For example, we all say OPEC should lend directly to the LDC's. Has there been any thought given to the IMF serving as

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guarantor of OPEC loans so that OPEC does not need to assume the risk inherent in direct lending?

Governor WALLICH. The Fund has had a number of new ideas under review. The main one, the substitution account, is in a somewhat different area. It may facilitate the recycling by making alternative assets available.

As far as guaranteeing is concerned, this is something that it originally was thought the World Bank might do when it was set up in 1945. It turned out that it is not as flexible and effective an instrument as is direct lending. Turning to the case of the IMF, without being able to speak for the institution or for the Treasury, I would like to say that because the IMF does not have a callable capital, it just has the contributions of its members, and it has its assets claims on countries that have drawn on the Fund. Therefore, it is not really an institution at which one would look as a grantor.

Mr. LEACH. A number of ideas are circulating for strengthening the IMF, whether it be the progress toward a substitution account or the possibility of IMF borrowing in commercial markets or directly from OPEC, cofinancing with commercial banks, and the possibility as well of extending or making permanent the Witteveen Facility.

Would you care to comment on any of these or in what directions you might recommend the IMF to proceed?

Governor WALLICH. I think each of these things deserves to be explored. Borrowing from OPEC has been done before, and it could probably be done again. Borrowing from the market raises some problems; for instance, I believe the IMF would have to borrow in SDR's, given its constitution, and the market is not accustomed to that. But it is not inconceivable that that could be bridged. Cofinancing, or parallel financing, as is it sometimes called in connection with the IMF, seems desirable.

The Fund's biggest leverage really comes in mobilizing private capital flows and so helping a country to regain its equilibrium that it becomes a reliable debtor. Then it is bankable or can issue bonds or attract capital in other ways. It is this catalytic function of the Fund that perhaps has the biggest dollar impact.

Mr. LEACH. Let me just pursue one other area which has struck me as potentially problematic and I would appreciate your judgment on it. As the Euromarkets grow in size and as the Fed prudently has placed some restraint on the increase in American banks' functions in these markets, by definition the presence of foreign banks in these markets has increased proportionately. And yet the foreign banks are probably, in general, more leveraged than the American banks.

Given that development and the fact that one out of every two deposits in the Eurocurrency market is interbank lending, do you see any potential problem that if a foreign bank gets into difficulty that it may leverage difficulties into the American banking system?

And recognizing with that question, again to the great credit of the Fed and the other central banks, that there has been greater awareness that individual governments are going to be the lenders of last resort, but do you see that as a potential difficulty? And if you were to predict a problem in international banking, would you

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say that it would be more likely to arise from foreign-bank difficulties and if so, exactly where?

Governor WALLICH. The need for a consolidated balance sheet approach is underlined by your comments, Congressman Leach. Many countries don't have that yet. As a result, their banks have subsidiaries, for instance, operating in foreign countries of which they don't know what risks thay have undertaken.

That needs to be remedied and that is at least underway in some countries. There is a widespread agreement on the need for close prudential supervision of the Euromarket—that is, to make sure that the banks are sound. That does not by itself say much about the volume of lending. Sound banks can lend much or little. It does say something about the qualtiy of the loans and their procedures.

We have had one bad event some time ago in the Euromarket. The failures of Herstatt and Franklin had also some side effects in the Euromarket. I think this has taught us the importance of watching the banks closely. And in that vein, unlike the problem of the volume of lending in the creation of the Euromarket, there is no disagreement.

Mr. LEACH. I would like to end with one brief comment, and that is on a very extraneous subject. As a Representative from Iowa, I would like to stress to a member of the Federal Reserve Board that for the first time in recent memory the smaller banks do look as if they are going to be having a very difficult time in the next 3 to 6 months; and that Fed actions, which have certain prudence on the monetary growth side also are devastating to the agricultural community, especially if carried on for a substantial length of time.

I am hopeful that the Fed will be very conscious of the borrowing aspect of the agricultural community, upon which these banks depend. I know the Fed monitors the economy very closely, but sometimes it is difficult to keep in mind the specific problems of rural America with all the other priorities of bringing down inflation and protecting the dollar.

I would only put forward the strong plea, as a Midwest Representative, that the consequences of Fed policy for the agricultural economy be followed very carefully. Thank you.

Chairman NEAL. Thank you, Mr. Leach.

We have told our witnesses that the hearings would end at noon. It is now 12:20. And I would just like to thank our witnesses for being with us today, and would welcome any further suggestions that they may have as we proceed with this legislation or with other work of the subcommittee.

Mr. CAVANAUGH. Mr. Chairman?

Chairman NEAL. Yes?

Mr. CAVANAUGH. I know the chairman wants to try and mark this legislation up tomorrow. But I just would again like to raise the issue—and the chairman has been remarkably indulgent to all of my requests. But one of the requests that I did make was to request that a set of the major commercial bank lenders be requested to testify, which the chairman graciously did extend the invitation to, I believe, six major commercial banks engaged in international lending, all of whom have declined the invitation of the subcommittee, which is a highly unusual occurrence.

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I consulted with subcommittee staff and made several contacts myself to the declining financial institutions, and received rather curt rebuffs, that they were not interested; not only not interested in testifying, but unwilling to supply either me or the subcommittee with any justification for their reluctance to testify.

And I would just like to express the view that I think it is wholly inappropriate for the subcommittee to go forward under those circumstances, that it leaves the subcommittee vulnerable in a historic sense to further unresponsiveness by witnesses. I think that it is impossible for us to presume that the major financial institutions of this country engaged in foreign lending aren't interested and affected by the outcome of this legislation; and that in fact the economic stability of our country and the world is not affected by the future lending policies that they will adopt.

I would just again like to make the request that either we pursue the banks in some more formal manner and if not—if we are not successful in securing their presence, at a minimum secure the dignity of a justification for why they should not respond. But I can suggest that I have been personally insulted by those banks that I did contact. I think that that is a reflection upon the entire committee and the Congress itself, our process.

And I would hope that the chairman would not want to proceed without pursuing the matter of the commercial banks, or at least not leaving the matter in the unfortunate condition that it is in at this moment, of them simply feeling that they can dismiss a committee of the Congress with no explanation.

Chairman NEAL. Well, let me just say that we differed, you and I, on the importance of the banks' testimony. I still do not think that it makes much difference one way or the other.

I know your first request was that we get a lending officer from serveral banks to come in and tell us what their plans might be for the future. And I would just say that, as I think the testimony of both out witnesses this morning indicates, that their judgments will be based upon economic conditions as they evolve over time, and that they couldn't give us any better view into the future than our own regulators, or than we ourselves have at this point. And my own view was and is that this legislation is so important that we need to move ahead with it.

And we did not give the banks much time, and one of the things that they mentioned to our staff director when he called was that they didn't have very much time and there were a lot of things going on and they did not have adequate time to prepare testimony on this. And as I indicated to you, I just didn't feel very strongly about this.

If we did feel very strongly about it, if the subcommittee felt strongly about it or if the subcommittee in the future should feel strongly on this subject or any other, there are ways that we can force attendance from witnesses. And I would personally, if I felt strongly about it, not hestitate to use those powers at any time to force the appearance of any witness that we felt was critical to the deliberations of the subcommitee.

In this case we happen to disagree about the importance of these witnesses. So I would hope that we would as a matter of fact move to markup tomorrow morning, and I would hope that we have

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adequate attendance to make that possible. But if that is not true, I hope that we would move to markup just as soon as we could after that.

And with that said, I would like to say that the subcommittee stands in adjournment.

[Whereupon, at 12:25 p.m., the subcommittee was adjourned.]

[The statement of the National Taxpayers Legal Fund, by Mark Hulbert, research economist, follows:]

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STATEMENT OF
MARK HULBERT, RESEARCH ECONOMIST
On Behalf of
THE NATIONAL TAXPAYERS LEGAL FUND

Before the
Subcommittee on International Trade, Investment and Monetary Policy
House Committee on Banking, Finance and Urban Affairs

The National Taxpayers Legal Fund is a non-profit and non-partisan educational organization, created to research the economic, legal and political aspects of taxation. For the past two years, the Legal Fund has sponsored research into the role of the international banks in recycling Petro-dollars and the cost to the taxpayers of their activities. We are grateful for the opportunity to present to the Committee the findings of our research as it pertains to H.R. 5970.

My statement is divided into several parts. I will first discuss the merits of the arguments used to support increasing the U.S. quota to the International Monetary Fund. I will then attempt to assess who will benefit from increasing IMF's liquidity. On the basis of these considerations, I will conclude that the public interest is best served by defeating H.R. 5970.

THE BUDGETARY TREATMENT OF H.R. 5970

Before assessing the merits of H.R. 5970, we need to have a clear idea of what costs this legislation will place on the American public. The Administration argues that an increase in the U.S. quota to the IMF will not increase the budget deficit. This is because any payment of funds to the

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IMF will be offset by a budgetary receipt that represents the increased U.S. reserve position in the Fund. Increasing the U.S. quota in the Fund, so the argument goes, is just like depositing money in a bank: it is an exchange of one asset for another, and no expenditure of resources takes place.

This is a dangerous illusion because it encourages Congress to consider this legislation as if it would have no costs. But in fact it will cost the American public a substantial amount. Regardless of whether or not the increase is counted as part of the budget, the Treasury will have to turn to the capital markets to borrow the amount. Yet, as was so clear in the debate over the Chrysler bail-out, the capital markets are a zero-sum game: increased government borrowing squeezes some private borrowers out of the market. This Committee must judge whether or not the benefits of this legislation outweigh the costs of squeezing private borrowers out of the capital markets.

H.R. 5970 will have other costs as well. Unlike a bank, the IMF pays interest on a country's reserves only to the extent of that country's creditor position in the Fund (and then only at a 9.225% annual rate). But because the U.S. is likely to remain a net borrower from the IMF, the U.S. will receive no interest on its reserves in the IMF. Assuming a 15% interest rate on Treasury borrowing, the quota increase could cost the government as much as $825 million each year in increased interest. Interest on the national debt, of course, is a budget item.

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The budgetary treatment of the quota increase is misleading in yet another way as well. The U.S. can spend its reserves in the IMF only to help finance its balance of payments deficits. When such spending does take place, it represents an expenditure of resources on goods and services. As such, it takes on the relevant features of deficit spending: it allows the government to buy goods and services beyond the tax revenues it has received. This spending will be inflationary.

In other words, an increase in the U.S. quota to the IMF will place substantial costs on the American public. We need to keep these costs clearly in mind to determine whether the merits of the legislation outweigh the costs.

THE SUPPOSED "NEED" TO INCREASE IMF QUOTAS

A principal argument in support of this legislation is that IMF resources have been allowed to dwindle. For example, the Administration argues that aggregate quotas in the IMF, despite four previous increases, have fallen to about four percent of the value of world imports, compared to an eight to twelve percent level in the 1960's, and a ten to fourteen percent level in the 1950's. The proposed 50% increase is thus needed to halt this decline.

This argument is unpersuasive. The comparison with the 1950's and 1960's is not helpful because the IMF's role underwent a drastic change in the early 1970's. Up until 1971, the IMF's role was to preserve exchange rate stability, providing temporary balance of payments finance. Since 1971,

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however, exchange rates have floated more or less freely, and the demand for balance of payments financing has fallen. If exchange rates were to floatcompletely freely, there would be no need for any balance of payments financing whatsoever, including IMF financing. Thus one would expect IMF financing to be less important today than in previous decades.

Yet, if we compare the magnitude of IMF quotas to the total of deficit countries' balance of payments deficits (calculated on the official settlements basis), no discernible decline has occurred since OPEC's inception. This is shown in the following table:

IMF QUOTAS, WORLD MONETARY RESERVES, AND BALANCE OF PAYMENTS DEFICITS, 1974-8

All Non Oil Exporting Countries

(Amounts in billion SDRs)

	1974	1975	1976	1977	1978
Aggregated Payments Deficits	22.04	14.23	18.11	34.38	29.95
IMF Quotas	27.77	27.79	27.79	27.80	35.23
Quotas/Deficits	1.26	1.95	1.53	0.81	1.18
Total Monetary Reserves	256.3	228.6	244.2	297.3	369.2
Reserves/Deficits	11.63	16.06	13.48	8.65	12.33

(Oil Exporting countries were excluded because they have accumulated large reserves and have little balance of payments needs.
Monetary reserves include gold at current prices.
Source: International Monetary Fund, Balance of Payments Yearbook, 1979; International Financial Statistics, various issues.

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If anything, the Table underestimates the growth of IMF liquidity over the decade: the Table does not count SDR allocations, financing available under the Supplementary Financing Facility, and liquidity available to the IMF under the General Agreements to Borrow, etc. Furthermore, as the Table also shows, the value of total monetary reserves has also kept pace with the growth of balance of payments deficits. In other words, arguments based on the supposed decline in IMF resources do not have the unequivocal support of the facts.

But arguments based on projections of future balance of payments financing needs face an even more fundamental difficulty. In a world of floating exchange rates, the need for balance of payments financing of necessity must equal the available financing. Arguments that there will be an increased need for such financing in the future already assume that such financing will be available. Thus it makes no sense to use such arguments to conclude that there is a need for more financing.

Arguments about the need for future financing in effect boil down to the claim that the banks will be more reluctant to finance current account imbalances. But how much importance should we give to this claim? As we might recall, all American banks except for Citibank expressed a similar reluctance six years ago, prior to OPEC's initial quadrupling of oil prices. Yet, if anything, that reluctance too quickly turned into an excessive zeal in extending loans to the less developed countries (LDCs).

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The reason for this is simple. A deposit appears on a bank's books as a liability, and if it is not offset by a loan the deposit will represent a loss to the bank. The recipients of huge OPEC deposits after the oil price hikes in 1974 and 1975, the banks were desperate to find opportunities to loan those amounts. Yet at the same time, the recession caused loan demand in the OECD countries to decline. Lending to the LDCs was the banks' only major opportunity for avoiding losses on their deposits. Despite the banks' protestations of reluctance again today, as long as OPEC keeps depositing large amounts in the Eurodollar market, we have every reason to believe that the banks will continue to lend large amounts to the LDCs.

A final argument used by those to support this legislation is that increased IMF quotas are necessary to lure LDCs into accepting Fund conditionality. If IMF resources are allowed to dwindle, so the argument goes, there will be little incentive for a country to secure a loan and thereby subject itself to the conditions. But this argument does not hold water. As the proponents of H.R. 5970 concede, even with the quota increase the IMF will finance only a small fraction of LDC current account imbalances. Thus the LDCs will still have to rely to a large extent on private bank loans. Given this, why would a country subject itself to Fund conditionality? Only because the country is convinced that IMF conditions, harsh as they may be, are nevertheless less stringent than those accompanying private bank loans. Increasing IMF quotas thus could have the effect of making balance of

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payments financing more easily obtainable. This hardly would be a desirable solution to a problem created by excessive balance of payments financing.

Sometimes, however, the IMF acts as a catalyst for private bank financing. A country will approach the Fund not because its conditions are less stringent but because the private banks will otherwise refuse to extend loans. If this is the case, then the IMF does not need additional liquidity in order to place conditions on the LDCs. The banks can require countries to adhere to Fund conditions regardless of the eventual size of IMF financing.

The arguments in favor of H.R. 5970 fall flat. Arguments about the increased need for balance of payments financing are confused. Claims that banks will not be able to continue a high degree of LDC lending ring hollow. And increased IMF resources are not needed if the goal is to impose stricter conditions on the LDCs.

Why then are the banks and the Administration supporting this legislation? By examining the long-term effects of H.R. 5970, we will discover the interests of each in supporting this bill.

THE BENEFICIARIES OF H.R. 5970

The Treasury

The U.S. Treasury's support of this legislation arises from protectionist motivations. In the absence of the greater availability of financing the IMF would provide, LDC currencies would have to depreciate. This would have the effect of making LDC goods and services more competitive

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in the world markets, at the expense of OECD and especially American exports. This would exacerbate U.S. current account imbalances and place foreign exchange pressure on the value of the dollar.

With greater balance of payments financing, however, the LDCs will be able to avoid the adjustment needed to overcome chronic balance of payments deficits. Their current account deficits will remain high, and their currencies will stay overvalued. This will allow the U.S. to maintain the dollar at its prevent value. The legislation will thus allow the U.S. to export its own balance of payments deficits to the Third World.

International liquidity for the past decade has been all too plentiful, with the result that balance of payments financing has been too available. This has contributed to worldwide inflation by allowing countries to postpone the inevitable adjustment processes. It is hypocritical of the U.S. to domestically espouse the virtues of austerity while exporting its inflation to the LDCs.

The Banks

The large banks that have a high degree of exposure in the LDCs are supporting this legislation because they are worried that some LDCs will be unable to service their debt. They believe that greater IMF resources will help insure that the LDCs will remain solvent. Increasing the quotas in the IMF thus protects the banks from the possible default on LDC loans.

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Before discussing the merits of thus protecting the banks, I would like to discuss the so-called "bank bail-out hypothesis." According to this hypothesis, the banks look to the IMF to pay off bad loans and thus rescue them from an otherwise hopeless situation. As has been pointed out when this has been discussed by the Subcommittee, the hypothesis is mistaken. On the whole, IMF financing has been accompanied by an increase, rather than by a reduction, in private lending. The banks have not used IMF financing to extricate themselves from risky lending situations.

While this form of the bailout hypothesis is mistaken, the whole discussion arises from a confusion over banking practices. Above all else, the banks strive to keep loans on the books. Given possible default on a loan, a bank is not interested in liquidating the loan; instead, the bank strives to reschedule the loan so that it can remain on the books. In fact, a bank would rather extend a new loan, enabling the country to service its old debt, than liquidate the old debt altogether. This has been shown over and over again as threatened LDC defaults have given way to debt reschedulings.

A genuine bank "bail out" occurs when the IMF enters the scene, enabling an LDC to continue servicing its old debt and to secure new loans. Far from refuting the bail out hypothesis, the fact that private bank lending increases in the wake of IMF financing illustrates the degree to which the IMF protects the banks' interests. If indeed private bank loans increase because of IMF financing, then

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IMF financing will postpone, rather than hasten, the adjustment to chronic balance of payments deficits. If the banks were genuinely interested in promoting LDC adjustment to those deficits, they would oppose H.R. 5970. Instead, they are interested in keeping LDC loan demand at a high level, and thus they are supporting this legislation.

The question before this committee should be whether or not it is the proper role of the U.S. government, through the IMF, to protect the international banks from possible LDC loan defaults. LDC lending was risky from the very beginning, and the banks were aware of those risks. Nevertheless, competition among the banks for the lucrative Third World market has led them to expose themselves to a dangerous degree. And now, the banks are turning to governmental institutions to protect them from the risks they incurred in the process.

LDC insolvency is due in large part to the excessive ease of bank financing over the past decade. The LDCs were encouraged to use the bank loans for current consumption. As a result, most of the LDCs grew no more able to repay the loans as the debts matured. The percent of new bank loans devoted to servicing old debt has steadily grown. In 1976, for example, the total LDC debt service burden on medium and long-term debt amounted to $30 billion, or 61% of total medium and long-term loans extended by private banks in that year. According to World Bank projections, by 1985 the debt service burden will be $166 billion per year, or 88% of the total medium and long-term loans the LDCs will be able to secure

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from the private banks. By 1990, the debt service burden will be $304 billion per year, or 95% of all private bank loans. There is no light at the end of this tunnel of "development" for the LDCs, and the banks are becoming worried. But the banks have only to blame themselves for the predicament.

In this process, the banks have become insolvent as well. Prudent banking, for example, requires that the maturities of loans be only moderately longer than the maturities of deposits. In that way the banks can protect themselves from unexpected deposit withdrawls. But in lending to the LDCs, the banks have violated this principle of sound banking. On the average, Eurodollar deposits have short maturities, whereas loans to LDCs have medium to long-term maturities. As a result, the banks are vulnerable to unexpected deposit withdrawls.

According to the Bank of England, a large portion of Eurodollar deposits are overnight funds. In a survey of banks conducted last August, the Bank of England discoverd that over a fifth of Eurodeposits mature in less than eight days; 38% have maturities of less than 30 days. Only 5% of Eurodeposits have maturities that exceed one year.

Euroloans, on the other hand, have much longer maturities, and this is especially so for LDC loans. According to figures published by the Comptroller of the Currency, nearly half of the loans extended by U.S. banks to the LDCs mature in more than a year. Thus, if depositors at Eurobanks (e.g. OPEC investors) failed to rollover their short-term deposits,

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the banks would be faced with a liquidity crisis. This is precisely the crisis which U.S. banks, in particular Chase Manhattan, faced when Iran threatened to withdraw its deposits from American banks.

This vulnerability to deposit withdrawls has been growing. Competition among banks in the Third World has caused maturities to lengthen. According to the World Bank, the average maturity on medium and long-term loans to LDCs in 1975 was 7.8 years. By 1978, that average had increased to 8.9 years.

Why did the banks overextend themselves in this way? Again, it was an overzealous pursuit of short-term profits at the expense of the long-term safety of the banking system. By borrowing short and lending long, the banks have been able to take advantage of low short-term interest rates. Salomon Bros. estimates that such practices increased the average earnings on overseas assets by 8 to 20% in 1975.

Competition among the banks for the LDC market has increased vulnerability in other ways as well. Interest rate spreads should reflect the degree of risk the banks incur in lending. In any case, according to bank analysts, spreads should drop no lower than about 1%. When the banks first loaned to the LDCs, spreads were in the two to two-and-a-half percent range, as opposed to a 3/4 to one percent range for prime borrowers. This increased spread in LDC lending was one of the initial attractions of Third World lending. Since then, however, competition has forced spreads to decline. Today, spreads are commonly less than one percent, and spreads

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as low as one-half percent or less are not rare. These spreads are totally out of touch with the risks the banks incur in lending to the LDCs.

Thus, as we have seen, much of the risk that exists in the international economy today can be traced to imprudent practices on the part of the banks. The banks encouraged the LDCs to borrow to a foolish degree, and now the LDCs are facing insolvency. The banks overextended themselves in the process, and are now vulnerable to any irregularities in debt service. This should place the banks' appeal for government help in a new light.

Competition among banks means nothing if banks can turn to government institutions for help as soon as they encounter difficulties. LDC lending was fraught with difficulties from the beginning, and the brewing storm clouds were visible for all to see. Nevertheless, the banks continued on their course, with wanton disregard for the risks. They should not be allowed to turn to the government for protection.

This legislation is misguided in another way as well. By providing greater liquidity for the LDCs, the IMF will allow the LDCs to borrow more than otherwise would be the case. No matter how large the risks are today, they can grow only larger as the LDCs and the banks postpone adjustment. The total LDC debt service burden today is slightly more than $50 billion per year, and the banks are worried about default and are hoping the IMF can help. A few billions might postpone the crisis, but it cannot avert it. What will the banks ask of Congress and the IMF in

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1985 when the debt service burden will total $166 billion? What will they ask when the burden totals $304 billion in 1990?

We have grown too scared of letting the market work. The international economy has shown a high degree of resiliency in the past in the face of bank collapses and LDC loan defaults. But by postponing fundamental adjustments, we build rigidities into the market that strain that resiliency. In the process we make worldwide inflation all the more intractable and render the international economy less and less able to withstand the shocks of default.

CONCLUSION

In conclusion, Mr. Chairman, we can now see why the public interest demands a defeat of H.R. 5970. It will cost the American public as much as $5.5 billion in the private capital markets and as much as $825 million per year in interest on the national debt. For that price we obtain very little: for a few short years the U.S. will be able to export its inflation and the banks will be able to continue their foolish activities in the Third World.

H.R. 5970 definitely is not a bargain.

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TO AMEND THE BRETTON WOODS AGREEMENTS ACT TO AUTHORIZE CONSENT TO AN INCREASE IN THE U.S. QUOTA IN THE INTERNATIONAL MONETARY FUND

MONDAY, APRIL 21, 1980

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON INTERNATIONAL TRADE,
INVESTMENT AND MONETARY POLICY,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, D.C.

The subcommittee met at 9:35 a.m., in room 2222, Rayburn House Office Building, Hon. Stephen L. Neal (chairman of the subcommittee) presiding.

Present: Representatives Neal, Cavanaugh, Blanchard, Leach, and Stanton.

Chairman NEAL. The subcommittee will come to order. This morning the Subcommittee on International Trade, Investment and Monetary Policy meets for hearings on two separate bills.

First, we will hear testimony from the Honorable C. Fred Bergsten, Assistant Secretary of the Treasury for International Affairs on H.R. 7051. This bill authorizes appropriations for the international affairs functions of the Department of the Treasury for fiscal year 1981.

After we have completed questioning Mr. Bergsten, we will turn to a panel of representatives from several major banks who will testify on the problem of bank lending to less developed countries.

Mr. Bergsten, we are delighted to have you here this morning. And please proceed as you will.

STATEMENT OF HON. C. FRED BERGSTEN, ASSISTANT SECRETARY OF THE TREASURY FOR INTERNATIONAL AFFAIRS

Mr. BERGSTEN. Thank you very much, Mr. Chairman.

I do have a prepared statement that elaborates, in some details, our request for authorization of funding for the international affairs function of the Treasury Department for fiscal year 1981. With your permission, I would submit that for the record and summarize it very briefly at this time.

Chairman NEAL. We will put that entire statement in the record, without objection.

Mr. BERGSTEN. Thank you.

In summarizing it, I would just make three or four basic points.

The Treasury Department, as you well know, Mr. Chairman, pays a very wide ranging and central role in the implementation of

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U.S. international economic policy. The Secretary of the Treasury is U.S. Governor in the International Monetary Fund, the World Bank, all the regional development banks, chairs the United States-Saudi Joint Economic Commission, the United States-China and the United States-Soviet Economic Commissions.

The Secretary, as the chief economic official of the U.S. Government, plays a central and pervasive role in a whole range of U.S. international economic operations—on the monetary front, trade issues, financial and development issues as well. So Treasury plays a central role in the whole range of international economic and financial issues and therefore must have the kind of staffing support that permits us to carry out those policy objectives in an effective way.

I have always taken great pride in my tenure at Treasury that we are able to do that with a very small staff and a very tight budgetary operation.

The authorizations that we are requesting from you for fiscal year 1981 totals about $24.8 million, $23.7 million for our basic expenses, an additional $1.1 million for authorized cost-of-living increases in pay and overseas allowances and benefits. This is a $600,000 cut from the earlier request that we submitted as part of our overall budget balancing exercise. We went back to the drawing board, looked for whatever cuts we could come up with, found $600,000, which is about 3 percent that we were able to cut off our earlier request.

As a result, the proposal we have before you is less than 4 percent above the authorized level for the current fiscal year, which obviously means a significant decline in real terms. We think we can maintain the high standard of Treasury performance within this budgetary situation. And it is that we are seeking your support for today.

I would add two or three component elements to that. One, as I said earlier, we do this with what I would regard as a fairly small staffing operation. When I came in back at the start of 1977, there were 555 permanent positions in the international affairs function of the Treasury. Today our request encompasses 460, a cut of 95, or about 17 percent from where we were 4 years ago. So we have made every effort to reduce both financial costs and personnel allocations in our effort to be maximally cost-effective in carrying out our responsibilities.

One line item of importance in our request is travel. Obviously, a lot that we do requires international travel. We therefore have to spend some money on it. Nevertheless, we have also made some major cutbacks. Travel expenses back in 1975 exceeded $1.3 million. This year we are requesting only a little over $1 million. So despite the inflation, despite the depreciation of the dollar, which raises the foreign currency cost of a lot of our travel, we have managed to cut our travel expenses by 20 percent in the last 5 years. That is something in which I take great personal pride, as well as feel that, again, we have made every effort to economize.

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ASIAN DEVELOPMENT BANK SALARY EQUALIZATION

There is one new item in our proposed authorization I would like to dwell on in my final comment. That is a request for $700,000 to permit us to equalize the salaries of U.S. nationals employed by the Asian Development Bank with other nationals employed by that Bank.

As you know, Mr. Chairman, in all of the multilateral banks we have carried out a major and largely successful initiative to cut salaries, reduce administrative costs, limit personnel expenditures. As I say, we have succeeded in that, importantly in the World Bank, in the IMF, and in all of the Banks.

And indeed the Asian Bank is regarded as perhaps the most effectively administered and most tightly costed of all the institutions. Nevertheless, partly because of that, an important problem has developed. There has been a dramatic change in the cost situation in Manila in the last few years, with the cost of living rising there by 70 percent in the last 3 years, compared with about a 30 percent increase here in Washington. Housing costs, in particular, have soared, raising dramatically the living costs of people employed there.

Nevertheless, staff salaries at the Asian Bank are established on the assumption they will be exempt from national income taxes. And that is true for all countries except for citizens of the United States and the Philippines. The salaries of U.S. citizens are subject to U.S. income tax.

And as a result of the rapid cost increases in Manila and the 1978 revision of U.S. tax laws, an enormous gap has opened up in the real income of Americans working at the ADB compared with other nationals working at the ADB and, I might say, with other Americans employed in our own Embassy in the Philippines.

As a result, there has been a dramatic exodus of American nationals from the Asian Development Bank. Just last year 11 out of the 31 Americans in the Bank resigned. Other resignations are expected in the near future. And out of 54 total managerial jobs in the Bank, now only 5 are held by Americans; whereas earlier both the number and the proportion of Americans was higher.

As you know, we strongly support the work of the regional banks, including the Asian Development Bank. We feel it is important to have at least a reasonable number of Americans in place.

We therefore feel that in this unique case we should equalize the salaries of American citizens to the level enjoyed by other nationals. Therefore, we have asked for an authorization and an appropriation of about $700,000 to do that in a fair way.

Mr. Chairman, thank you very much. We appreciate your considering our request and hope that it will be possible to pass it expeditiously.

[Mr. Bergsten's prepared statement follows:]

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STATEMENT OF THE HONORABLE C. FRED BERGSTEN
ASSISTANT SECRETARY OF THE TREASURY
FOR INTERNATIONAL AFFAIRS
BEFORE THE
SUBCOMMITTEE ON INTERNATIONAL TRADE,
INVESTMENT AND MONETARY POLICY
HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

Mr. Chairman and Members of the Committee:

The Treasury Department, through its international affairs functions, plays a key role in assuring that U.S. international economic policies support the needs of our domestic economy and enhance the economic benefits of our global interdependence. The Secretary of the Treasury has major international responsibilities: he is Governor for the United States in the International Monetary Fund, the World Bank and other multilateral development banks; co-Chairman of the Saudi Arabian-United States Joint Commission on Economic Cooperation; co-Chairman of the U.S.-U.S.S.R. Commercial Commission; and co-chairman of the U.S.-China Joint Economic Commission. The Secretary oversees U.S. international monetary policy and operations, represents the United States in discussions and negotiations of bilateral and international monetary and financial issues with other nations, and closely assists the President at economic summit meetings. Treasury's views provide important input in the interagency determination of U.S. policies on international trade, development, energy and commodities issues.

Our fight against inflation, in particular, must include international as well as domestic policy initiatives. A stable dollar, a fair and open system of international trade and investment, and efforts to stabilize international food and commodity prices are essential aspects of our efforts to avoid additional inflationary pressures. Smoothly-functioning international

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monetary arrangements are important to the preservation of an open and efficient system of international trade and investment, which are vital to our economic interests, and to the maintenance of a strong and competitive U.S. economy.

Such activities as these, on the part of the Secretary and other senior Treasury officials, require highly professional staff support. There is a continuing need for knowledge and analysis of economic conditions and policies abroad, for development and representation of U.S. positions at staff level with foreign representatives, and for relating U.S. foreign economic policy activities to the national interests of the United States.

The authorization of appropriations that we have requested for fiscal year 1981 for the international affairs function is approximately $25.4 million - comprised of $24.3 million for the basic expenses and $1.1 million which would be available only for the payment of authorized cost of living increases in pay and overseas allowances and benefits. Since this request for authorization was submitted, the appropriation request was amended as part of the President's program to balance the FY 1981 budget. The amended budget request is for $23.7 million -- a decrease of $0.6 million from the original request. Due to the technical requirements of the Congressional Budget Act of 1974, we have also requested authorization of such sums as may be necessary for fiscal year 1982.

Secretary Miller and I are deeply concerned that the international affairs functions of the Treasury Department be carried out in as efficient a manner as possible. While our overall international responsibilities have grown more complex and demanding, we have been able to meet our requirements through more efficient use of existing resources and a minimum of expanded

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budget authority. In 1976, for example, there were 555 permanent positions. The request before you today is for 460 permanent positions. The basic increase in funds requested for 1981 is slightly less than 4 percent above the authorized level for the current fiscal year.

The nature of the Treasury's international work requires significant foreign travel. This is unavoidable, but we have made major and continuing efforts to reduce travel expenses. Travel expenses in 1975 were $1,326,000. In 1979 we spent $1,033,000 on foreign travel. In 1981 we are requesting $1,057,000 or an increase of approximately 2 percent over last year's actual expenses. Inflation and dollar depreciation notwithstanding, we have managed to reduce travel expenses by 20 percent in the last five years. Other changes in the budget include an increase of $1,558,000 to maintain current levels of operations. These increased requirements are partially offset by expenditure reductions totaling $1,424,000 including reductions of $634,000 due to productivity increases.

The one new significant item in our proposed authorization is a program increase of $700,000 to permit us to equalize the salaries of U.S. nationals employed by the Asian Development Bank (ADB) with other nationals employed by the Bank.

The ADB has a well-deserved reputation for prudent policy, effective management and low administrative costs. In part, the Bank's ability to keep administrative costs low resulted from the relatively low cost of living in Manila. However, in recent years there has been a dramatic change in this situation, putting severe pressure on U.S. nationals employed at the Bank, and leading to a sharp erosion in U.S. representation on the Bank's staff.

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The cost of living has increased by 70 percent in Manila over the last three years, compared to a 32 percent increase in Washington. Housing costs in particular have soared and are now a major deterrent to accepting employment with the ADB. For example, in today's housing market in Manila, the United States Government spends over $25,000 per year to provide a married GS-16 employee, with two or more dependents, with appropriate accommodations. Housing costs are, therefore, about twice those of equivalent accommodations in the Washington, D.C. area, and are increasing at a faster rate.

ADB staff salaries are established on the assumption that they will be exempt from national income taxes. U.S. citizens are the only expatriates on the staff of the Bank whose salaries are subject to taxes. The 1978 revision of U.S. tax laws regarding foreign earned income has placed these Americans at a severe disadvantage; they now receive, on the average, 20 percent less than other nationals at the ADB. The differences in disposable incomes after taxes and housing expenses, compared with U.S. Government officials in Manila at the same basic rate of pay, are even greater.

These problems have made employment with the ADB a serious hardship for the U.S. nationals already there, and has made recruitment of qualified U.S. citizens almost impossible.

During 1979, eleven Americans out of 31 resigned from the ADB, and other resignations are expected in the near future. There are now only five Americans, out of a total of 54, at a level equivalent to GS-16 or above in the Bank, compared to seven from Japan, and 15 from South Asia. Other member countries exert maximum efforts to place their nationals at these levels in all international organizations. If the U.S. presence were to erode permanently, the philosophical make-up of the ADB staff could change.

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Continued employment of U.S. citizens on the staff of the ADB is of considerable policy importance to the United States, as it helps contribute to more effective implementation of ADB policy and projects.

The United States currently has cumulative subscriptions in the Bank of over $1.3 billion, and these contributions to the Bank are growing by several hundred million dollars each year. Congress has long urged employment of U.S. nationals on the staffs of international organizations, and provides similar salary adjustments for U.S. citizens employed at all U.N. agencies through appropriation to the Department of State.

I should also mention one other technical provision of the proposed authorization bill. The first section of the bill corrects an oversight in Treasury's existing legislation to further assure that we can pay, for our overseas employees performing international affairs functions, allowances and benefits comparable to those provided to employees of the Department of State. Currently, Treasury is authorized to pay allowances and benefits comparable to those provided to State Department employees by Title IX of the Foreign Service Act of 1946. However, additional allowances for educational travel for dependents of State Department employees are authorized by another statutory provision (5 U.S.C. 5924 (4) (B)). Under this provision, State Department employees receive travel allowances for one round trip for each dependent each year for secondary education and two round trips for each dependent each year for undergraduate education in the United States. Treasury Department employees, however, receive travel allowances for only one round trip for secondary school and one round trip for undergraduate education in the United States for each dependent during the employee's entire overseas tour of duty. The proposed amendment would correct this present inequity and align Treasury travel allowances for such dependents with those of the State Departmnt.

This concludes my statement, Mr. Chairman. I would be happy to answer any questions that the committee may have.

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Chairman NEAL. I thank you for your testimony and for the excellent job that you all are doing there. It has been my observation that you are doing it in a cost-effective and efficient way. I would like to commend you for your efforts.

I have no questions.

Mr. Cavanaugh, do you have any questions of Mr. Bergsten?

Mr. CAVANAUGH. I don't have any questions, Mr. Chairman.

I am sorry that I missed the testimony. But I would have to say that I think that in the area of international development banks, the Treasury is doing a lot better job than we are. We hope that you will be able to continue. Obviously, we are not, together, doing a good enough job of selling the American people on the vital function that these institutions serve for our Nation and our leadership. So that presents a challenge for both of us.

But as I came in, I understand you were concerned about our losing personnel from these institutions?

Mr. BERGSTEN. The Asian Development Bank has a peculiar problem because of the living costs in Manila and U.S. tax treatment of ADB incomes. We are, therefore, asking a unique kind of authorization and appropriation, to offset the tax payments that the American employees in the Asian Bank make, of $700,000. It is important, both in real terms and in psychological terms, to try to stem the exodus of Americans from the bank in Manila and have our people play their full role in carrying out the operation of that institution.

Mr. CAVANAUGH. Well, it has been my experience that it is critical, if we are to maintain an appropriate level of influence to serve our country's interests, that we have adequate personnel throughout the ranks of these institutions.

It isn't enough for us to simply maintain our voting quota and our voting share. If we are to really effectuate policy of the institutions, we have to have the personnel.

I would be happy to do whatever we can to insure that we maintain that total institutional participation.

Thank you, Mr. Chairman.

Chairman NEAL. Thank you, Mr. Cavanaugh.

PRC AND TAIWAN STATUS IN THE IMF

On another subject briefly, Mr. Bergsten, since you are here, I wonder if you would give us a little insight into precisely what transpired in the IMF regarding the PRC and Taiwan and how you see that from your perspective.

Mr. BERGSTEN. Two votes took place in the IMF Board last week on China issues. The first occurred last Monday, when the Board voted to "restitute" to Taiwan gold which has been held in abeyance since the overall gold "restitution" was voted back in 1975. It goes back to the decision of the Fund in 1975 to restore to member countries one-sixth of the gold that each of them had put into the Fund at its inception.

At that time, it was voted to hold in abeyance the share of gold that was China's because of uncertainty about who represented China and the whole representation issue. At that time, the United

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States supported "restitution" to Taiwan, but it was not voted by the majority.

This past Monday, the majority did vote to "restitute" the gold to Taiwan. What that means is Taiwan got its original gold at a price of 35 SDR per ounce, which obviously is a good deal less than today's market prices; so that represented a substantial benefit to Taiwan as the gold was "restituted" to it.

On Thursday, the Fund Board voted to recognize the People's Republic of China as the representative of China in the institution.

So, the sum of these two events means that the People's Republic has now assumed the China seat in the institution. Taiwan has therefore been replaced as China's representative. Taiwan did so, I think, in a fair and equitable way, having had restored to Taiwan the gold which it had put into the Fund. It also paid off all of its debts to the Fund, and therefore, left in a completely clean position.

We have taken the view that it would be highly desirable if all parties involved could agree to work out some continuing association for Taiwan with the IMF. And efforts to do that and find out how that might be done are now underway in the Fund and in discussions with the participating countries. I would hope that that could be worked out in the fairly near future in a positive way. But I think it is too soon yet to know for sure.

Chairman NEAL. Are there any precedents for that sort of association?

Mr. BERGSTEN. There are some precedents. We don't know whether they will be applicable in this case. There is the now-become-famous example of the Netherlands Antilles, which although part of the Kingdom of the Netherlands, has had direct relationships with the IMF for a good many years. It has article VIII consultation; it has a page of its own statistics in the International Financial Statistics publication; and—always working through the Kingdom of the Netherlands, the central political point—has had independent and direct relationships with the IMF. That is one model that has been suggested.

Other ideas have also been proposed, and we are pursuing those now to see if something could be arranged that would achieve what we think would be highly desirable, namely, continued relationships between Taiwan and the IMF.

Chairman NEAL. Do you have any sense of the PRC's attitude toward some other form of relationship?

Mr. BERGSTEN. There is some indication that they might be prepared to see some kind of relationship continue. Again, I think it would have to depend on the details of that relationship, the implications, obviously, for the positions of the various parties involved. But there has been an indication of openmindedness on their part, and that's one of the parameters that now govern the effort to find them a way to achieve their purpose.

Chairman NEAL. When Dèng Xiaoping was here, you will remember he said something to the effect that it was their policy that the people living on Taiwan could maintain their own local government with their own local business and trade systems and their own local defense. That is not, as you know, a part of the formal agreement, but I think that we all think of that as part of the

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understanding that exists. And it is recognized by a majority of the people of the world.

It would seem to me that that would offer some hope that they might be able to continue some kind of relationship with the Fund. It seems to me that it is important.

I am thinking of our IMF legislation now. I can see some objections being raised to that legislation on these grounds, and I am, frankly, at a loss as to how best to answer those kinds of concerns.

I can point out, as you have, that there are negotiations ongoing. I would certainly hate to see some sort of amendment that would require a successful end to those negotiations. And I would think it would be unnecessary.

I guess this new relationship is one that is not in conflict with our own national decisions or the decisions of other countries; would that not be true?

Mr. BERGSTEN. That is right. The United States welcomed and supported the membership of the People's Republic in the Fund, their taking of the China seat. But we have made clear throughout both our desire to see the Taiwanese gold "restituted" to Taiwan—and that was done last week—and also the desirability of working out this continued association. Particularly in light of what you say, we will address that issue with a great deal of urgency and try to get it worked out equitably and fairly just as soon as we can.

Chairman NEAL. I believe that would help.

We will have a markup of the IMF legislation before the full committee pretty soon, before May 12. Is there any chance of getting something resolved?

Mr. BERGSTEN. It is hard for me to predict, Mr. Chairman, how quickly that can be done. We are working on it with a sense of urgency. We will redouble that in light of the time factors that you mention and make every effort to see that it is done. I cannot give you a firm prediction at this time, but we will keep you fully informed as the process proceeds and try to achieve the outcome in time to help your process.

Chairman NEAL. Well, thank you. That would be most helpful.

Mr. Leach.

Mr. LEACH. I have no questions.

Chairman NEAL. Well, Mr. Bergsten, thank you, again, for being with us.

Mr. CAVANAUGH. Could I just ask, what is China's participation? What will their contribution be?

Mr. BERGSTEN. They have come in by replacing Taiwan in the existing China seat, which has a quota of 550 million SDR, which is something like 1¼ percent—I will have to check the precise number, but that is about right—of the existing voting shares.

What happened was that the original China quota, way back at the time of Bretton Woods, was actually the third highest of any country. But then, with the change of the situation in China, the absolute level of the China quota never changed, whereas, everybody else's rose through the various quota increases that have occurred. So, the China share sank very sharply.

And I think one would not be surprised if the People's Republic, now having assumed the seat, would look to an increase in that quota at some subsequent point. However, they have come in now

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with the existing quota, which is a little over 1 percent; and any change in that would have to be accepted, voted, agreed by the full membership.

SOVIET UNION AND THE IMF

Mr. CAVANAUGH. Does Chinese membership put any kind of pressure on the Soviet Union to apply for membership? How will it affect the Soviet's position in the world, economically? What would be our view on their membership?

Mr. BERGSTEN. I can only speculate because, to my knowledge, there have been no official statements of any type by the Soviet Union on that question. I should say, with regard to the China seat itself, we have always felt that association of major socialist countries with the IMF, the World Bank, the GATT, are highly desirable in the sense that they represent a major victory for our system. If people want to join the system that we place so much reliance on—it is a market-oriented system, it is a free enterprise system, it requires data disclosure, collaboration in an international setting, and therefore something that we think would help leaven the systems that they carry out.

Mr. CAVANAUGH. Do you think we have them now?

Mr. BERGSTEN. I regard it as a desirable step. I would not go beyond that at this point. But it is an indicator of the attraction of the kinds of operations that we carried out and that you all work on with such vigor and diligence here in the Fund, in the Bank, and elsewhere.

We really have not heard anything from the Soviet Union. There has, over a period of years, been an occasional glimmer of interest in IMF membership by the Soviets. I am not aware of anything in recent years. We, therefore, just have not addressed that question in any practical way in the recent past.

Chairman NEAL. If I might ask——

Mr. CAVANAUGH. I think that is an excellent argument, Mr. Chairman.

I think you have placed the chairman in a difficult position here. He has been fending me off on the left for months, and he is roused the right, just as he is had the legislation ready to move. But I think that that is a persuasive argument even to the right, that to bring the nonmarket systems into the basic international structure of the market system is a persuasive compliment to the dominance of that system eventually.

INTERNATIONAL MONETARY FUND

Chairman NEAL. What would happen if one of the major, or even the minor, socialist systems came to the Fund for aid and the Fund suggested, as it does, that they take the steps that market economies think are necessary to stabilize and to make healthy economies? Wouldn't that provide some interesting interplay?

Mr. BERGSTEN. It would. You will recall that Romania has been a member of the Fund now for a number of years and has been going through the annual consultations with the Fund. To my knowledge—my experts can check me if I am wrong—Romania has never drawn from the IMF. Oh—Romania has drawn. But the kind of question you raise has not often come up.

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Chairman NEAL. But Romania is the only other nonmarket—there is Yugoslavia.

Mr. BERGSTEN. I am sorry. Yugoslavia has been a member for some time. There are other countries that are nonmarket in some of the senses we would mention. In all cases, the Fund's articles of agreement, the basic articles, require it to respect the domestic social, and political system of the country.

Nevertheless, in pursuing a stabilization program or standby agreement with a member country, the Fund will insist on effective measures to achieve the usual economic objectives. So it would apply these standards to any member and it might very well be interesting to see what would happen in those particular cases.

Chairman NEAL. The amounts of money that the PRC might need might be interesting, also.

Mr. BERGSTEN. Well, recall, though, that even though it is a big country, its involvement in the international economy has so far been very small. Its stated policy now is to expand that role, and its entry now into the IMF is of course part of that new strategy. Nevertheless, its level of trade, its level of financial transactions, all of those operations, are very, very small as a share of its economy relative to that of most other countries.

Nevertheless, I am sure you are right that its involvement will be growing over time. But certainly in light of its stated economic objectives—I think we should not be surprised if China, having now entered the Fund, would at some point seek an increase in its quota. But that would have to be worked out with all the member countries and agreed through the usual procedures.

Chairman NEAL. Mr. Leach?

EXCHANGE STABILIZATION FUND

Mr. LEACH. I would like to return briefly to your requested $24.8 million for the international affairs function. As I recall, we used to fund that directly from Treasury resources and through the exchange stabilization fund.

Last year at this time you gave us the condition of the ESF. Do you have an updated one?

Mr. BERGSTEN. Yes, we do. We have supplied you with the latest statement. Our fiscal year 1979 audit report is in the final stages of preparation. That too will be available within a few weeks or a month. But we have continued——

Mr. LEACH. Can you summarize their position at the end of fiscal year 1979?

Mr. BERGSTEN. Yes. What I have in mind is the numbers for the end of December, actually. The equity position of the ESF has improved over the last year to year-and-a-half. As you know, we apply these very conservative accounting principles to the ESF. It therefore continues to have a small net negative equity position, on the order of a couple hundred million dollars, mainly the legacy of paying off the Swiss franc denominated bonds that were issued in the early 1960's. But that negative position has shrunk over the course of the last year by $100 million or so, and stands at about the level that I have mentioned as of the latest reporting date.

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Mr. LEACH. To use a benchmark date, for example January 20, 1977, would you say that the Fund is in a stronger or a weaker position from that benchmark?

Mr. BERGSTEN. In any intangible sense, enormously stronger. But let me just see what the numbers say.

[Pause.]

Mr. BERGSTEN. I don't have the balance sheet as of January 20, 1977. That was, however, before the Swiss franc denominated liabilities had been paid off. So at that point the equity position was positive. However, the liabilities were being carried and in a contingent sense had not yet been paid off.

Mr. LEACH. They were entirely paid off?

Mr. BERGSTEN. They were entirely paid off, that is right.

Mr. LEACH. I only raise this as a minor issue, because obviously the liabilities were incurred earlier. However, if the position of the dollar had not deteriorated, you would still be on the positive side. So, if you just look at the ESF in your accounting principles, we've in a fairly unusual situation over the last several years, being on the negative side.

Granted, you do have the capacity to convert SDR's. But it certainly is not a very cheerful position for the ESF to be in. Frankly, it is turning into a deficit situation which, in my judgment, is the exclusive reason Treasury came to the Congress and asked for a specific authorization to fund this function, even though there had prior to that time congressional pressure to have greater accountability.

But I do think this is worthy of note because of the dollars involved in ESF transactions. The administrative function involves a very trivial sum of money for an enormously consequential policy function. Hundreds of millions of dollars can be saved or lost with good or bad management. We ought to be generous in funding the best minds in America in this small Treasury operation as anywhere else in government.

So I certainly support the authorization, but I do think it is fair to note that things have gone backward in the last 3 years.

Thank you.

Mr. BERGSTEN. We appreciate your support for our authorization.

Chairman NEAL. If I may comment on one thing you said, as a matter of fact, when I first became chairman of the subcommittee I asked the staff what they thought were the top orders of priority of things we had to deal with at that time. One member of the staff who is no longer with us said that because there had been—it is not because of that statement that he is no longer with us.

[Laughter.]

INTERNATIONAL AFFAIRS APPROPRIATION

Chairman NEAL. He said that in his opinion the top priority would be to separate out the administrative budget from the ESF because of some of the very unfavorable press that it had received. This was pictured by the press as a hidden, secret slush fund that the Treasury could use for lavish travel and so on.

So we, in cooperation with the Under Secretary for Monetary Affairs, Tony Solomon, shared this view, and we worked together

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on legislation that would separate out this budget so that we would be able to keep an eye on it. Really, to the best of my knowledge there was absolutely no subterfuge of any kind intended by that action. It in fact was an attempt to reform something that had been a nagging problem for a number of years.

Mr. LEACH. If the gentleman would yield, I share that background of concern and you are entirely right. However, it is interesting that the Treasury adamantly opposed making the ESF a line item in the budget until such time as it went into a negative deficit position and the Treasury could not fund ESF ongoing operations unless Treasury made the rather remarkable decision of converting SDR's to give the ESF greater balance.

So Treasury had absolutely no choice but to come to this Congress to do what we had asked for it to do. I might say it is an interesting position as well for the Congress. It is not that we like to fund parts of any Government department and make it a line item issue. But I agree fully with the chairman that there have been some noteworthy funding allocations from ESF, and we all know about them.

I am not convinced that the Treasury would have made this request if they were running in a positive surplus position and making more than $25 million a year in the Fund. I am not persuaded they would have requested to make that a line item.

Mr. BERGSTEN. Mr. Chairman, can I just support what you said, though, because this is an important point. I mentioned a moment ago that as of September 1977 the ESF still had a sizable positive balance in its equity account. We had made the decision well before that to go on budget and had proposed well before September of 1977 that the shift be made from ESF funding of the administrative expenses over to congressional authorization and appropriation.

Our judgment, quite frankly and quite simply, was that the position we inherited was anachronistic in an age of open government, in an age of close working collaboration between the administration and Congress; that for a small component to be exempted from that treatment, however attractive it might be in some senses, was in fact anachronistic and inconsistent with the whole approach that we wanted to pursue.

So we made the judgment to seek that shift in the very first months after coming into office and proposed it. It did not actually get legislated for a while. But we had proposed it earlier along, while it was still a very positive balance sheet. And I might note that, though the net equity position did become negative, we have something like $4 billion worth of dollar holdings in the ESF which could be used as a source of funding if one wanted to do it. That is only an aside.

The basic point was that our judgment was to remove the anachronism, go on budget—and that was one of the first decisions we made back in one of the early months of the administration.

Chairman NEAL. It just took a change in administrations to get it going, Mr. Leach.

[Laughter.]

Mr. LEACH. I can see that. But when you get right back to the romanticism of Government, I think that from a taxpayer point of

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view one would prefer an anachronism in a fiscally sound fund to modernism in a fiscally deficit fund.

I would also point out that perhaps you were barely in surplus in September 1977, but to derive something in the neighborhood of $25 million of revenues demands approximately $250 million in surplus, unless you use very imaginative techniques of coming up with operating money.

Thank you.

Mr. NEAL. Mr. Cavanaugh, anything further?

[No response.]

Mr. NEAL. Mr. Bergsten, thank you again.

Mr. BERGSTEN. Thank you very much.

Chairman NEAL. I would now like to welcome as our next witnesses H. Robert Heller, vice president for international economics, Bank of America, Alexander M. Vagliano, executive vice president, international division, Morgan Guaranty Trust Co., and Dimitri Balatsos, vice president, international economics, Manufacturers Hanover. Gentlemen, please make yourselves comfortable here.

Our concern with bank lending to less developed countries has come out of our hearings on legislation to increase the U.S. quota in the International Monetary Fund. A major argument in support of this increase is the prognosis that U.S. bank lending to LDC's will not be able to finance as large a share of their projected current account deficits as it did in the few years after the oil price increase in 1974.

If that is true, and we need to understand why, alternative channels for recycling the OPEC surpluses may have to be found. If they are not found, many countries will not be able to continue to import both oil and other goods in the volume they need for economic development. They could suffer a severe balance of payments crisis.

If several countries suffered such a crisis at once, particularly if they already had large outstanding debt, the consequences could easily extend beyond their own economies. The world financial system could be endangered. We cannot at present easily assess that risk. It could prove to be minimal, as it was in similar conditions after the 1974 oil price increase.

Nonetheless, we need to do what we can to meet the problem should it prove serious. The most important thing we can do right now is to approve the IMF quota increase. It may soon be necessary to go beyond that and look for other ways to facilitate the flow of funds from OPEC to oil importing countries.

Even if the major U.S. banks reduce somewhat their share of the financing of deficits of oil importing countries, we can expect their international lending to remain large in absolute terms. The risks attached to this large international exposure will probably increase over the next few years.

Last week the central bank governors meeting at the Bank for International Settlements issued a press communique in which they warned of potential dangers to the international banking system. I would like to insert a copy of that communique into the record of these hearings.

[The press communique referred to follows:]

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15th April 1980

PRESS COMMUNIQUE

1. At their meetings in Basle on 10th March and 14th April the central-bank Governors of the Group of Ten countries and Switzerland exchanged views on the evolution during recent years, and the future prospects, of the international banking system in general, and the Euro-currency market in particular.

2. The Governors recognise the important part played by the banks in recycling large surpluses which have arisen during the last few years. They noted that international bank lending aggregates have been expanding at an annual rate of some 25 per cent. Moreover, the contribution of the international banking system to recycling the large OPEC surpluses that have re-emerged will lead to further substantial growth of these aggregates.

3. In view of the present volume of international bank lending and of its prospective future rôle the Governors are agreed on the importance of maintaining the soundness and stability of the international banking system and of seeking to avoid any undesirable effects either worldwide or on the conduct of policy in particular countries.

4. With these considerations in mind, the Governors have decided to strengthen regular and systematic monitoring of international banking developments, with a view to assessing their significance for the world economy, for the economies of individual countries, including particularly the operation of their domestic monetary policies, and for the soundness of the international banking system as a whole. A Standing Committee on Euro-markets will consider the international banking statistics compiled by the BIS and other relevant information and report to the Governors at least twice a year, and more frequently if developments call for it. These arrangements for closer surveillance could provide a framework for intensifying, if appropriate, co-operation on monetary policies between the countries concerned.

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5. Recognising that individual banks, or the international banking system as a whole, could in future be exposed to greater risks than in the past, the Governors re-affirm the cardinal importance which they attach to the maintenance of sound banking standards - particularly with regard to capital adequacy, liquidity and concentration of risks. To this end they place high priority on bringing into full effect the initiatives already taken by the Committee on Banking Regulations and Supervisory Practices with regard to the supervision of banks' international business on a consolidated basis, improved assessment of country risk exposure, and the development of more comprehensive and consistent data for monitoring the extent of banks' maturity transformation.

6. The Governors note that differences in competitive conditions between domestic and international banking that arise out of official regulations and policies stimulate growth of international bank lending in general; and that transactions channelled through the Euro-currency market can pose problems for the effectiveness of domestic monetary policy in those countries where such differences are particularly significant. The Governors will continue efforts already being made to reduce the differences of competitive conditions, fully recognising the difficulties arising from differences in the national structure and traditions of banking systems.

Chairman NEAL. I would also like to insert into the record a statement we have received from the Federal Deposit Insurance Corporation in response to our inquiry concerning the FDIC's monitoring and evaluation of foreign lending by banks under their supervision. Without objection, that is so ordered.

[The FDIC statement regarding supervision of foreign lending by insured State nonmember banks follows:]

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FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, D.C. 20429

OFFICE OF THE CHAIRMAN

April 2, 1980

Honorable Stephen L. Neal, Chairman
Subcommittee on International Trade,
Investment and Monetary Policy
Committee on Banking, Finance and
Urban Affairs
House of Representatives
3138 HOB Annex II
Washington, D.C. 20515

Dear Mr. Chairman:

Subject: Federal Deposit Insurance Corporation Supervision of Foreign Lending by Insured State Nonmember Banks

This will respond to your March 21, 1980 letter where you asked me to provide a written statement on the Corporation's role in the Country Exposure Lending Survey, our activities in monitoring and evaluating foreign lending by banks under FDIC supervision and some indication of the magnitude of lending by those banks.

Attached is a statement prepared by FDIC staff which responds to the points raised in your letter. We trust this information will prove useful to the Subcommittee in its deliberations on this important area.

Sincerely,

Irvine H. Sprague
Chairman

Enclosure

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Staff Memorandum Re: FDIC Supervision of Foreign Lending by Insured State Nonmember Banks

This will reply to the March 21, 1980 letter from Congressman Stephen L. Neal, Chairman of the Subcommittee on International Trade, Investment and Monetary Policy, Committee on Banking, Finance and Urban Affairs of the House of Representatives. Chairman Neal has requested comments on the Corporation's involvement in the Country Exposure Lending Survey, a brief description of the Corporation's activities in monitoring and evaluating foreign lending by insured State nonmember banks, as well as some indication of the magnitude of foreign lending by those banks.

COUNTRY EXPOSURE LENDING SURVEY

The Country Exposure Lending Survey is a reporting mechanism that was developed by the Office of the Comptroller of the Currency, the Federal Reserve System and the FDIC. The development of the survey was prompted by the increased awareness that foreign lending by U.S. banks represents a material percentage of U.S. banks' lending activities. Furthermore, this form of bank lending introduced certain unique risk features not found in domestic lending. In recognition of the foregoing, in July of 1977 the three Federal bank regulatory agencies conducted an experimental survey of large U.S. banks, generally banks with total assets of $300 million or more, to determine the number and characteristics of banks with extensive foreign lending activities and to test the survey form which had been developed. As a result of the initial experiment, the agencies agreed to institute a regular report on country exposure on a semiannual basis.

Appended as Attachment I is a copy of both the Country Exposure Report form currently in use and the instructions thereto. The report is required to be filed semiannually by any U.S. bank (or its U.S. bank holding company) that (1) has a foreign branch or a foreign subsidiary, or an Edge or Agreement Corporation subsidiary, or a branch in Puerto Rico or in any U.S. possession; and (2) has, on a fully consolidated basis, claims on residents of foreign countries totaling more than $20 million. The results of the July, 1977 experiment indicated that collection of data from banks with the aforementioned operating characteristics and volume of foreign lending activities would result in a reasonably comprehensive picture of foreign lending activity in the U.S. banking system, while at the same time, minimizing the reporting burden. The data from individual banks is treated as confidential, however, aggregate data for all banks participating in the survey are published. Thus, the survey has served a useful purpose in enabling the bank regulatory authorities to systematically monitor foreign exposure of U.S. banks with material international activity and to publish aggregate data that could be helpful to the banking industry in making credit judgments in this area.

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Foreign Outstandings of Insured State Nonmember Banks

The subcommittee has requested some indication of the volume of foreign lending by insured State nonmember banks. The June 30, 1979 Country Exposure Lending Survey reflected outstandings of approximately $3.6 billion at 13 insured State nonmember banks required to file the report. This total is comprised of approximately $ 8 bil ion in claims on banks located in foreign jurisdictions, approximately $0.8 billion in loans to public sector entities and another $1 billion in claims on private sector borrowers. The maturity distribution of these assets reflects the predominance of bank placements as the primary lending medium with over $2.1 b llion of claims due to mature in less than one year The remainder of foreign outstandings bear the following maturity characteristics: one to two years - $0.3 billion; over two years to five years - $0.7 billion; and over five years $0.5 billion. If adjustments are made for claims on foreign offices of U.S. banks and loans in foreign countries guaranteed by U.S. residents, the aggregate outstandings of reporting banks declines to approximately $3 billion.

At the present time, we are still collecting data for the December 31, 1979, as of date. Based on our preliminary review of data received to date, it is anticipated that total foreign claims of 17 insured State nonmember banks which are required to file the Country Exposure Report will increase to approximately $4 billion.

Although the reporting criteria previously described make it unnecessary for all insured nonmember banks with foreign loans to file a report, it is believed the foregoing data represent the majority of foreign lending by FDIC supervised banks.

Evaluation and Monitoring of Foreign Lending

In response to increased size and complexity of international lending activities of U.S. banks, the three Federal bank regulatory agencies have found it desirable to develop a uniform system whereby the country risk components of the international loan portfolios of U.S. banks are reviewed and evaluated in a consistent manner by examiners of each of the agencies. Under this system, country risk factors are segregated from other lending risk criteria and dealt with in a separate section of the report of examination.

For the most part, risks in international lending are the same as in domestic lending. Commercial credit risks stemming from present and future standing of the borrower must be appraised and evaluated in the usual manner. However, international lending presents an additiona risk component, i.e., country risk. It is the primary factor that different ates interna ional lending from domestic lending. Broadly speaking, country risk encompasses an entire spectrum of risk arising from economic social, legal, and political conditions within a foreign country that may result in favorable or unfavorable consequences for borrowers in that country. Specifically, country risk analysis is aimed at assessing the likelihood of political or social upheaval, nationalization or expropriation, government repudiation of external debts, and exchange controls or foreign exchange shortfalls that might preclude

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timely repayment of interest or principal on external obligations. In these circumstances, payment of interest or principal may be delayed or loan restructuring may be necessary. A rare but possible event is an actual loan default.

In recognition of the fact that country risk evaluation involves a plethora of judgmental evaluations none of which can be gauged with mathematical certainty and many of which are largely subjective, the three bank regulatory authorities have opted for a diversification of risk framework a the most rational means of protection against unpredictable changes n the economic, social or political fortunes of a country or group of countries. In assessing the adequacy of portfolio diversification, the examiner focuses attention on the bank's exposure in the country in relation to the capital funds of the bank. When a bank appears to have allocated too large a percentage of its capital funds relative to potential risks indicated by analysis of economic, political and social factors within the country, examiners are required to provide commentary to the bank. When a country has encountered significant economic or politica difficulty which has resulted in an interruption in debt servicing or which points to an imminent interruption in deb service, bank exposure in that country may be subjected to class fication as either Substandard, Doubtful or Loss depending on the gravity of the situation. Examiners are also required to analyze the management systems utilized by the bank to mon tor and control country risk exposure in its international loan por fol o the bank's system for establishing limits for lending and investing in a country, and the bank's methods for analyzing country risk. Where deficiencies are uncovered in management systems, examiners are required to include commentary in the report of examination with the objective of achieving corrective action, where necessary.

The system is largely administered by a nine-member committee comprised of experienced examiners and other analytical personnel from the Federal Reserve System, the Office of the Comptro ler of the Currency and the FDIC. The committee, known as the Interagency Country Exposure Review Commi tee has the responsibility for reviewing economic conditions in countries where U.S banks extend credit; ascertaining appropriate levels of capital a which concentrations require comment; determining when classification of bank exposure due to country risk is in order; and preparing commentaries on developments in foreign countries for use by examiners. In carrying out its responsibilities, the committee utilizes country studies especially prepared for its use by Federal Reserve System staff as well as supplementary analyses prepared by staff of each of the participating agencies and information from other available sources.

The foregoing system and procedures are used in all insured State nonmember banks which are required to participate in the Country Exposure Lending Survey as well as any other banks with aggregate outstandings to foreign borrowers of more than $20 million.

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(Rev. 12/77)

INSTRUCTIONS FOR PREPARING COUNTRY EXPOSURE REPORT
(FR 2036, CC 7610-08, FDIC 6502/03)

PART I - INTRODUCTION

The purpose of this report is to provide information on the distribution by country of the foreign claims held by United States banks and bank holding companies The individual returns are regarded by the Federal bank regulatory agencies as confidential and will not be voluntarily disclosed outside these agencies. Aggregated data that will not reveal the activities of individual banks will be published by the banking agencies Portions of the aggregated data will also be reported to the Bank for International Settlements as part of an international cooperative effort to compile and publish worldwide data on cross-border claims.

The following indicates in very general terms the nature of the information called for by the report; more precise descriptions, definitions, and instructions appear in Parts II, III, and IV of these instructions. The definitions of items are, for the most part, consistent with definitions used in the Instructions for the Report of Condition (Call Report) required by the banking agencies and for the revised Treasury International Capital (TIC) reports to be instituted in 1978 Where there are differences from the definitions used in these reports, such differences are noted in the appropriate paragraphs of these instructions

NOTE: One such difference throughout the report is that this report requires information on claims in both foreign and domestic offices, while the TIC report and the existing (12/76) Call Report instructions refer only to assets held by domestic banking offices.

The report has four sections: the first (columns 1-13), calls for information on the respondent's cross-border and non-local currency claims on foreigners; the second (columns 14-17), information on commitments to extend credit to foreigners; the third, information on the "local" currency activities with local residents of the respondent's offices in foreign countries; and the fourth, the net position of a respondent s offices in each country vis-a-vis its offices in other countries. In all of these sections the information is required on an individual country basis.

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In the first section, the report, in column 4, calls for total "cross-border claims" and "foreign-office nonlocal currency claims on local residents" based on the country of residence of the borrower. This total for each country is broken down in two ways: first, by the type of borrower (banks, public entities, and all other) in columns 1-3; second, by maturity in columns 5-8. Columns 9-12 indicate the extent to which the ultimate source of repayment may be in a country other than the country of domicile of the direct borrower. Thus, column 9 identifies those claims reported against banking offices in a particular country in column 1 that are guaranteed by banks (claims on bank branches are assumed to carry the "guarantee" of the head office) and others in other countries; for each country line, the entry in column 9 is a component of column 1 (and of the total column 4). Column 10 then reallocates all the entries of column 9 to record those amounts on the country lines of the guarantors. The grand totals of columns 9 and 10 are equal (including appropriate entries on the U.S. line).

Columns 11 and 12 play the same role with respect to direct claims on nonbank borrowers (columns 3 and 4) as that just described for columns 9 and 10 with respect to claims on banks.

Column 13 identifies for BIS purposes that portion of the claims in column 4 that are accounted for by "foreign-office non-local currency claims on local residents."

The second section of the report (columns 14-17) calls for the same type of information with respect to commitments to foreign public and private borrowers (including banks) that columns 1-3 and 9-12 do for credit outstanding: columns 14 and 15 indicate the country of domicile of the potential borrowers or account parties under such commitments; column 16 indicates what parts of the amounts recorded in columns 13 and 14 are guaranteed by residents of some other country, and column 17 reallocates these amounts to the lines for the countries of ultimate risk.

The third section of the report (columns 18 and 19) focuses on the claims and liabilities of the foreign offices of the respondent that are with local residents and denominated in the local currency.

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PART II - GENERAL INSTRUCTIONS

A. Who must report

The report is mandatory for commercial banks and/or bank holding companies as follows:

1. Every insured commercial bank in the 50 States of the United States, the District of Columbia, Puerto Rico, and U.S. territories and possessions, that meets both of the following criteria:

   (a) has at least one of the following:

      (1) a branch in a foreign country;
      (2) a subsidiary in a foreign country;
      (3) an Edge Act or Agreement subsidiary;
      (4) a branch in Puerto Rico or in any U.S. territory or possession (except that a bank with its head office in Puerto Rico or any U.S. territory or possession need not report if it meets only this criterion);

   AND (b) has, on a fully consolidated bank basis, total outstanding claims on residents of foreign countries exceeding $20 million.

2. Every bank holding company that is required to file the F.R. Y-6 report (Bank Holding Company Annual Report) and that owns only one bank satisfying the reporting criteria:

   (a) must file the report on a fully consolidated holding company basis if the subsidiary bank accounts for less than 90 per cent of the consolidated holding company's total claims on foreigners; in this case, no report need be filed for the individual bank;

   (b) may file the report, at its option, for either the individual bank on a fully consolidated bank basis or for the holding company on a fully consolidated bank holding company basis, if the subsidiary bank accounts for 90 per cent or more of the consolidated holding company's claims on foreigners.

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3. Every bank holding company that is required to file the F.R. Y-6 (Bank Holding Company Annual Report) and that owns two or more banks satisfying the reporting criteria:

   (a) must file a separate report on a consolidated bank basis for each bank that meets the reporting criteria;

   AND (b) if the subsidiary banks account for less than 90 per cent of the consolidated company's total claims on foreigners, must file a report for the bank holding company on a consolidated holding company basis.

B. Reporting basis

For institutions meeting the criteria for reporting described above, the information reported should cover all United States offices, foreign branches, branches in Puerto Rico, and U.S. territories and possessions, and significant majority-owned bank and nonbank domestic and foreign subsidiaries, including Edge and Agreement subsidiaries. The information should be reported on a fully consolidated basis (except for column 20 which specifically requests information on net positions of offices within the reporting bank or holding company). For reports from banks, the information should be consolidated in accordance with the procedures and tests of significance set forth in the instructions for preparation of Consolidated Reports of Condition (including Domestic and Foreign Subsidiaries). For reports from bank holding companies, the information should be consolidated in accordance with the principles set forth in the "Instructions to the Bank Holding Company Financial Supplement to Report F.R. Y-6." (For holding companies that file with the SEC, these principles are the same as those contained in SEC Regulation S-X.)

C. Filing of Reports

The report is to be filed semi-annually, as of the end of June and December. Two copies of the completed report should be submitted within 60 days of the reporting date. At least one full-size original copy of the report must be filed. One reduced-size photocopy is acceptable. Reporting national banks should submit their reports to the Comptroller of the Currency, International Operations Division, Washington, D. C. 20219. Reporting State member banks should submit their reports to the Federal Reserve Bank of the district in which the reporting institution is located. Reporting nonmember insured banks should submit their reports to the Federal Deposit Insurance Corporation, Division of Bank Supervision, Washington, D. C. 20429.

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Respondent bank holding companies should submit copies to both the District Federal Reserve Bank and to the supervisory agency for the bank that meets the reporting criteria.

D. Alternative reporting

In lieu of using the printed Country Exposure Report forms, the respondent may report the required data on computer print-outs that are in the identical format as the printed form, including names and codes of countries in the order in which they appear on the printed form. The computer print-out must be signed by a responsible officer of the reporting institution using the same statement that appears on the printed form.

E. Rounding

Amounts reported on this form should be rounded to the nearest million dollars; however, reporters who so desire may report in amounts less than $1 million provided such amounts are indicated by decimals.

PART III - DEFINITIONS OF CONCEPTS USED IN THE REPORT

A. Claims

The term "claims" used in this report refers to the following types of assets, as defined in the Instructions to the Report of Condition for insured commercial banks: interest-bearing balances with banks, securities, Federal funds sold and securities purchased under agreements to resell, loans (including own acceptances purchased acceptances of other banks purchased, discounted trade bills and other instruments defined as loans in the instructions to the Report of Condition), direct lease financing, investments in unconsolidated subsidiaries and associated companies, and customers liability on acceptances outstanding. It should be noted that the scope of "securities" in claims as defined above includes holdings of foreign long-term securities for the respondent's own account; such securities, which are covered in this report, are not included in the TIC reports filed with the Treasury Department.

Columns 1-13 of the report ask for information on those portions of claims as defined above that come within the scope of definitions B and C below with columns 9-12 being further defined by definition E. Similarly columns 14-17 are further defined by definitions B, C, and F. Column 18 asks for information on those claims that come within the scope of definition D.

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B. Cross-border claims

For purposes of this report, the cross-border claims of each reporting institution cover:

1. All claims, as defined in definition A above, of its U.S. offices (including offices in Puerto Rico and U.S. territories and possessions) against residents of foreign countries regardless of the currency in which the claim is denominated; and

2. All claims of each of its offices in a foreign country against residents of other foreign countries regardless of the currency in which denominated.

Since the reports are on a fully consolidated bank (or fully consolidated holding company) basis, cross-border claims exclude any claims against those foreign branches or foreign subsidiaries that are part of the consolidated bank (or consolidated holding company) However claims on unconsolidated subsidiaries of the reporting institution would be reported in the normal manner Thus, if a report is filed on a consolidated bank basis claims on foreign subsidiaries of its parent holding company would be reported, since such companies would not be included in the consolidation.

C. Foreign-office nonlocal currency claims on local residents

For purposes of this report foreign-office nonlocal currency claims on local residents" are those claims of a foreign office of the reporting institution that are both (1) against residents of the same country in which that office is domiciled, and (2) are denominated in the currency of another country, including the U.S. dollar. Claims denominated in the currency of the foreign country where the office is located are excluded. For example, claims by a London branch of the reporting bank on U.K. residents are covered in this category if the claims are denominated in dollars or in marks, but are not covered if they are denominated in British pounds.

Since the report is on a consolidated basis, "foreign-office nonlocal currency claims on local residents" exclude such claims by one office of the reporting institution in a given country against another office in the same country that is part of the consolidated institution.

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D. Foreign-office local currency activities with local residents

For purposes of this report, "foreign-office local currency claims on local residents" cover claims of a foreign office of the reporting institution that are both (1) against residents of the same country in which that office is domiciled, and (2) are denominated in the currency of that same country. (Similarly with liabilities.) Since the report is consolidated, this excludes any such claims on other offices of the consolidated reporting institution that are in the same country. Local currency claims of this category are to be reported only in column 18; liabilities of this type are reported in column 19.

E. Guaranteed claims

Columns 9-12 ask for certain information on "guaranteed" claims. (Columns 16 and 17 ask for similar information on commitments to extend credit where the resulting claims will be "guaranteed"; commitments are defined in definition F below. For the purposes of this report, "guaranteed" claims are those claims of the reporting institution for which a third party formally and legally obligates itself to repay the reporting institution s claims on the direct obligor if the latter fails to do so. Documents that do not establish firm legal obligations such as comfort letters or letters of awareness or intent, are not considered guarantees for the purpose of this report. The term "guaranteed" covers collateralized claims if the collateral is (a) tangible, liquid, readily-marketable (e.g. cash, gold certificates of deposit, or readily-marketable shares of stocks or bonds); AND (b) is both held and realizable outside of the country of residence of the borrower. In cases involving collateral, the residence of the "guaranteeing" party, for purposes of the report is the country in which the collateral is held unless the collateral is a security, in which case it is the country of residence of the party issuing the security.

F. Commitments

For purposes of this report, the term "commitments," used in connection with columns 14-17 refers to binding contractual obligations of the reporting institution and includes only the following items: fee-paid loan commitments (less any amounts actually outstanding on the loans); undisbursed portions of loans contracted where the funds are available at the borrower s request; commercial letters of credit either issued or confirmed; stand-by letters of credit and formal and legal guarantees issued. It excludes commitments that are subject to further bank approval before disbursement of funds and credit authorizations (internal guidance lines).

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The scope of commitments here differs from the concept of "loan commitments" used in other agency reports--e.g., the current Federal Reserve sample survey of loan commitments (FR 18a) and the recently discontinued semi-annual loan commitment supplement that was part of the Report of Condition- in that this report excludes loan commitments that are not fee-paid, refers to a different group of loans and includes additional types of commitments (e.g., stand-by letters of credit, commercial letters of credit, etc.)

G. Country lines (including international and regional institutions)

The report requires the information called for to be reported by country and by international and regional institution. Column (a) of the report form contains the list of countries and international institutions, for which the information is required arranged by geographical area, and column (b) lists codes for the countries and institutions for data processing purposes. The list of countries and institutions and their codes is based on the Geographical Classification published by the Department of the Treasury in January 1977 in connection with tha semi-annual TIC reports.

The reporting requirement, and the report form listing, includes international and regional organizations as well as individual countries. Claims on such organizations, even though located in the United States, should be reported opposite the line "International," "Western European Regional," "Eastern European Regional," "Latin American Regional," "Asian Regional," "African Regional," or "Middle Eastern Regional," as appropriate The regional entries cover organizations that are regional in scope such as the European Coal and Steel Community (Western Europe) the Inter-American Development Bank (Latin America) or the Asian Development Bank (Asia). The "International" entry covers organizations of a global character, such as the International Monetary Fund. For purposes of this report the Bank for International Settlements and the European Fund are to ba treated as "Other Europe," as in the TIC forms and not as "International" or "Regional." All international and regional institutions are to be reported as public entities for purposes of completing columns 1-3 and columns 13-14.

In addition to lines for foreign countries and international organizations, the form includes a line for the United States. This line is to be used only for entries in columns 9-12 and columns 16-17

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(all other columns on this line are crossed out on the form). Its use is explained below in the instructions to specific columns. For purposes of this line, "United States" is defined as the States of the United States the District of Columbia, the Commonwealth of Puerto Rico, American Samoa, the Canal Zone, Guam, Midway Island, the U.S. Virgin Islands and Wake Island.

PART IV - INSTRUCTIONS FOR SPECIFIC COLUMNS OF THE REPORT

Report in columns 1-4 on the country line of the country of residence of the borrower or on the international and regional lines as appropriate, cross-border claims and foreign-office non-local currency claims on local residents (as defined in Part III, definitions A, B, and C). Distribute these claims for each country among columns 1, 2, and 3, depending on whether the borrower is a "bank," "public" entity, or "other" type of borrower, as defined below under the individual column headings.

Column 4 is the total of columns 1-3 and reflects the total of cross-border claims and foreign-office nonlocal currency claims on local residents. DO NOT REPORT in columns 1-4 (or in any other column except column 18) any foreign-office local currency claims on local residents, as defined in Part III, definition D.

Column 1 - Banks

For purposes of this column, the term "bank" covers the following institutions in foreign countries: commercial banks, savings banks, discount houses, and other similar institutions accepting short-term deposits. It includes banking institutions owned by foreign governments unless such institutions function as central banks or banks of issue. Also included are the foreign branches of other U.S. commercial banks The definition of banks here is identical to that used for "banks in foreign countries" in the Report of Condition.

The claims on banks to be reported in this column include those loans to and deposit balances with foreign banks, as defined for Schedules A and C of the Report of Condition, that are cross-border claims or foreign-office nonlocal currency claims on local residents, as defined in Part III, definitions B and C. For purposes of this report, claims on foreign banks in column 1 also include acceptances of foreign banks that are held by the reporting institutions even though, in the Report of Condition, such holdings of bank acceptances are included in commercial and industrial loans, not in loans to banks.

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Column 2 - Public borrowers

For purposes of this column, the term "public" covers the following foreign institutions: central governments and departments of central governments of foreign countries and their possessions; foreign central banks stabilization funds exchange authorities, and government-owned banks that perform the functions of a central bank or a bank of issue corporations and other agencies of central governments, including development banks development institutions, and other agencies whose shares are majority-owned by the central government or its departments state, provincial and local governments of foreign countries and their departments and agencies; and nonbank commercial enterprises that are majority-owned by central governments, excluding,however banking institutions owned by governments that do not function as the central bank and/or bank of issue. This column also covers as "public" any international or regional organization or subordinate or affiliated agency thereof, created by treaty or convention between sovereign states. (The entries in this column for the international and regional organizations are entered on the lines of the report as stated in Part III, definition G.)

The definition of "public" here is consistent with that in the new Treasury International Capital (TIC) report that will be implemented in 1978 and with the definition of foreign governments to be incorporated in the revision of the Report of Condition to be implemented in 1978.

Column 3 - Other borrowers

All cross-border claims and foreign-office nonlocal currency claims on local residents not attributed to columns 1 and 2 are to be reported in column 3 It covers such claims on persons, businesses, and institutions other than "banks" and "public borrowers" as defined above for columns 1 and 2.

Column 4 - Total specified claims

Column 4 is the sum of columns 1, 2, and 3 and reflects the total of all "cross-border claims" and all "foreign-office nonlocal currency claims on local residents." It is also equal to the sum of columns 5, 6, 7, and 8.

Columns 5-8 - Breakdown by maturity

Report in these columns a breakdown by time remaining to maturity of total claims reported in column 4 for each country and

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international or regional institution line. The maturity distribution should reflect amortization or final maturity dates, as appropriate, and not interest adjustment dates or roll-over dates. Loans that are payable on demand should be reported in the column for maturities of one year and under, column 5. Loans for which scheduled repayments fall in more than one maturity column should be distributed to the appropriate maturity columns so as to reflect scheduled amortization.

Example:

The entries for a 7-year loan in the amount of $14 million that is repayable annually in equal instalments, with the first instalment due within one year of the date of the report, would be:

Column 5	Column 6	Column 7	Column 8
2	2	6	4

Column 9 - Claims on banks guaranteed in other countries

Report in column 9 on each country line the amounts reported in column 1 for that line that represent (1) claims on a branch or agency of a bank whose "head office" is located in another country, or (2) claims on a locally-chartered bank where the claim is guaranteed (as defined in Part III, definition E by a bank or other guarantor in another country (including the United States), or by an international institution. Claims on banks that are subsidiaries of banks in other countries are not to be reported in column 9 unless an explicit formal and legal guarantee is involved.

For each foreign country line, the entries in column 9 are components of the entries in column 1 on the corresponding line. Note that in addition to the foreign country lines, column 9 also calls for an entry for a United States line; the entry on this line in column 9 is not a component of any entry in columns 1 or 4. On the United States country line under column 9, report claims on U.S branches and agencies of foreign banks and any claims on New York investment companies engaged in banking or U.S. commercial banks that are majority-owned by foreigners where the claim carries the formal guarantee of a foreign resident.

No entries would be made against column 9 on the international institution lines as, by definition, there are no claims on "banks" reportable in column 1 on those lines, since international institutions and regional organizations are defined as "public."

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Column 10 - Claims on banks distributed by country of guarantor

Report in column 10 on each country line including the U.S. line (and each international and regional line if (2) below is applicable): (1) claims on banking offices in other countries (including the United States as represented by the U.S. line entry in column 9), the head office of which is located in the country indicated by the line stub, and (2) claims on banks in other countries guaranteed (as defined in Part III, definition E) by banks and others in the country (including the United States) indicated by the line stub or by international or regional institutions. On the U.S. line in column 10, report (1) claims on foreign branches of other U.S. banks, and (2) claims on foreign-chartered banks guaranteed by U.S. banks and by other U.S. residents.

The amounts reported in column 10 are a reallocation of the amounts reported in column 9; the grand total of column 10 should be equal to the total of column 9.

Examples for Columns 9 and 10:

(1) The respondent has a $10 million claim on a bank in the United Kingdom guaranteed by a French bank. Entries would be:

	Column 1	Column 9	Column 10
United Kingdom	10	10	--
France	--	--	10

(2) The respondent has a $10 million claim on a bank in Hong Kong that is a wholly-owned subsidiary of a Japanese bank but there is no formal guarantee by the Japanese bank. Entries would be:

	Column 1	Column 9	Column 10
Hong Kong	10	--	--
Japan	--	--	--

(3) The respondent has a $10 million claim on the Nassau branch of a U.S. bank. Entries would be:

	Column 1	Column 9	Column 10
Bahamas	10	10	--
United States	xx	--	10

(4) The respondent has a $10 million claim on the U.S. agency of an Italian bank. Entries would be:

	Column 1	Column 9	Column 10
Italy	--	--	10
United States	xx	10	--

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Columns 11 and 12 - Claims on public and "other" borrowers guaranteed in other countries

Column 11 is to be used to identify those claims on "public" entities and "others" (columns 2 and 3) that are guaranteed (as defined in Part III, definition E) by bank and nonbank "residents" of other countries (including the United States) in the same manner as column 9 identifies guaranteed claims on banks (column 1) On the U.S. line in column 11, report claims on U S. residents that are guaranteed by residents of other countries. The entry on the U.S. line of column 11 is not a component of columns 2 or 3 (or of column 4); all other entries in column 11 are components of the entries on the corresponding lines of column 2 or column 3.

Column 12 reallocates the guaranteed claims on nonbanks entered in column 11 to the countries (including the United States and international or regional institutions) of the guarantors in the same manner as column 10 reallocates the guaranteed claims on banks reported in column 9. The grand total of column 12 should be equal to the total of column 11. Portions of claims guaranteed by the Eximbank, Defense Department, or other U.S. government agencies should be reported in columns 2 or 3 and in 11 for the country of residence of the borrower, and in column 12 of the U.S. line (report in a similar manner any claims guaranteed by other U.S. residents).

Examples for Columns 11 and 12:

(1) The respondent has a $10 million claim on a Brazilian company guaranteed by a privately-owned Italian company. Entries would be:

	Column 3	Column 11	Column 12
Brazil	10	10	--
Italy	-	-	10

(2) The respondent has a $10 million claim on the U.S. subsidiary of a Belgian private company that has guaranteed the claim. Entries would be:

	Column 3	Column 11	Column 12
United States	xx	10	--
Belgium	--	--	10

(3) The respondent has a $10 million claim on the Belgian subsidiary of a U.K. company with a "comfort" letter from the parent. Entries would be:

	Column 3	Column 11	Column 12
Belgium	10	--	--
United Kingdom	-	-	-

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Column 13 - Memorandum: Foreign-office nonlocal currency claims on local residents (component of column 4)

Report in this column by country the outstanding claims of the respondent's foreign offices on the residents of the countries in which the offices are located where the claims are denominated in other than the local currency (e.g., dollar loans by a Japanese branch to residents of Japan), as defined in Part III, definition C.

(1) The Brazilian branch of the respondent has a dollar-denominated claim in the amount of $10 million on a bank in Brazil. Entries would be:

	Column 1	Column 13
Brazil	10	10

The amounts reported in this column for each country and international or regional institution line are components of the corresponding line entries of column 4 and are reflected, as appropriate, in columns 1-12.

Columns 14-17 - Commitments

These columns require reporting of the respondent's currently existing binding commitments (as defined in Part III, definition F) that may result in later acquisition of cross-border claims and foreign-office nonlocal currency claims on local residents, as defined in Part III, definitions A, B, and C. Do not report in these columns any commitments involving foreign-office local currency claims on local residents.

Column 14 - Commitments to public borrowers

Report in this column, by country, the specified commitments, as defined above, to public borrowers. Public borrowers are defined above in connection with column 2.

Column 15 - Commitments to banks and other nonpublic borrowers

Report in this column, by country, the specified commitments to "banks" and "other" borrowers as defined above in connection with columns 1 and 3.

Column 16 - Commitments guaranteed by residents in other countries

Report in column 16 those binding commitments to residents of each country reported in columns 14 and 15 that relate to the future

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acquisition of claims that will be guaranteed (as defined in Part III, definition E) by residents of other countries, including the United States. The foreign country entries in column 16 are components of the same country entries in columns 14 and 15. Column 16 of the U S. line is not a component of columns 14 and 15, which have no entries for the U.S. line. The U S line should include any binding commitments to lend or otherwise provide funds to U.S. agencies or branches of foreign banks or to other U.S entities where repayment of amounts to be extended under commitments are guaranteed by a foreign entity.

Column 17 - Commitments, distributed by country of guarantor

Report in column 17 on each country line (including the U.S. line) and each international or regional institution line the amount of binding commitments involving guarantees reported in column 16 that have guarantors in the countries listed The amounts reported in column 17 are a reallocation of the amounts reported in column 16. The total of column 17 must be equal to the total of column 16.

Column 18 - Foreign-office local currency claims on local residents

Report in this column, on each foreign country line, outstanding claims of the respondent s foreign office that are (1) on residents of the country in which the office is located, and (2) are denominated in the currency of that country (e.g., Belgian franc loans to residents of Belgium by a Belgian branch of the respondent). (See Part III, definition D These amounts are reported only in column 18 and not reflected in any other columns of the report.

Examples for Column 18:

(1) The Brazilian branch of the respondent has a cruzeiro-denominated claim worth the equivalent of $10 million on a bank in Brazil. Entries would be:

	Columns 1-13	Column 18
Brazil	--	10

In contrast:

(2) The Brazilian branch of the respondent has a dollar-denominated claim in the amount of $10 million on a bank in Brazil. Entries would be:

	Column 1	Column 13	Column 18
Brazil	10	10	--

(3) The London branch of the respondent has a cruzeiro-denominated claim worth the equivalent of $10 million on a bank in Brazil. Entries would be:

	Column 1	Column 13	Column 18
Brazil	10	--	--

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Column 19 - Foreign-office local currency liabilities to local residents

Report in this column, on each foreign country line, any liabilities of the respondent's foreign offices that are owed to residents of the country in which the office is located and are payable in the currency of that country (e.g., Deutschemark liabilities of the respondent's German branch to German residents.

Column 20 - Net due to or due from position of own foreign offices

Report in this column the net amounts the respondent's offices in the country identified on the line stubs have "due to" or "due from" all offices of the respondent, including U.S. offices, that are located outside of that country (e.g., the net amount that a German branch has "due to" the head office, and any other consolidated non-German office of the parent). Only a single net figure should be reported for all the offices of the respondent in a given country. If the offices in a given country taken together have a net "due to" position with all offices in all other countries combined, a positive figure should be reported; a net "due from" position should be indicated by brackets.

The amounts reported in this column represent the internal positions of offices within the consolidated bank or the consolidated holding company. They are therefore not reflected in any other columns of the report, all of which are on a fully-consolidated basis that eliminates these positions.

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ATTACHMENT I

Form CC 7810-08
FR 2036 (Approved 12/77, Expires 1/80)
FDIC 6502/03

PLEASE FILE TWO COPIES OF THIS REPORT. AT LEAST ONE FULL-SIZE COPY OF THIS FORM MUST BE FILED. ONE REDUCED-SIZE PHOTOCOPY IS ACCEPTABLE.

CHARTER NUMBER _____
REPORTING INSTITUTION _____
CITY _____
STATE _____

COUNTRY EXPOSURE REPORT
as of _____

The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation are of the view that individual bank information reported on this form is exempt from public disclosure under Section (b) (8) of the Freedom of Information Act (5 U.S.C 552 (b) (8)). Accordingly, individual bank information reported on this form will be considered confidential and will not be voluntarily disclosed by the Office of the Comptroller of the Currency, the Federal Reserve System, or the Federal Deposit Insurance Corporation.

I, _____ (Name), _____ (Title), an authorized officer of the bank or bank holding company named above, hereby certify on the _____ day of _____, 19__, that this report has been examined by me and is true and complete to the best of my knowledge and belief.

_____
(Signature)

Name, title, and phone number of person to whom inquires regarding this report may be directed:

_____ Name

_____ Title

(_____ Area Code/Phone Number

This report is required to be filed by national banks, State member banks and bank holding companies, and insured State nonmember commercial banks pursuant to authority contained in the following statutes:
Comptroller fo the Currency -- the National Bank Act, as amended (12 USC 161);
Board of Governors of the Federal Reserve System -- Section 11a of the Federal Reserve Act (12 USC 248a) and Section 5c of the Bank Holding Company Act (12 USC 1844c); and
Federal Deposit Insurance Corporation -- Sections 7 and 10 of the Federal Deposit Insurance Act (12 USC 1817 and 1820).

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COUNTRY EXPOSURE REPORT

(In millions of U.S. dollars)

(Name of Reporting Institution)

As of _____ (Date)

(Before completing this form, please read carefully the instructions and definitions for preparation of this report)

Country (a)	Code (b)	Cross-Border and Foreign-Office Non-Local Currency Claims: To Banks	To Public Borrowers	To All Other Borrowers	Total	Maturity Breakdown of Column (4): One year and Under	Over One Year to Two Years	Over Two Years to Five Years	Over Five Years	Claims On Banks, Reported in Column (1), and Their Offices (in Country(s) Included in Column (6)) Related to Another Country (c)	Redistribution of Claims on Banks, reported in Column (7), to Country(s) of Head Office (in Country(s) in (c))	Claims, Reported in Columns (2) and (3), with Guarantor(s) Located in Country(s)	Redistribution of Claims reported in Column (11), to Country(s) of Guarantor(s)	MEMORANDUM: Foreign-Office non-Local Currency Claims included in Column (4)	Cross-Border and Foreign-Office Non-Local Currency Contingencies: To Banks	To Public Borrowers	To Banks and Other Non-Public Borrowers	Redistribution of Contingents reported in Columns (14) and (15) with Guarantor(s) Located in Another Country(s)	Redistribution of Contingents reported in Column (15), to Country(s) of Guarantor(s)	Foreign-Office Local Currency Activities with Local Residents: Local Currency Claims on Local Residents	Local Currency Liabilities to Local Residents	Net Due To or (Due From) Own Related Offices in Other Countries (20)
		(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)	(17)	(18)	(19)	(20)	

COUNTRY EXPOSURE REPORT

(In millions of U.S. dollars)

(Before completing this form, please read carefully the instructions and definitions for preparation of this report)

(Name of Reporting Institution) _____

As of _____ (Date)

		Cross-Border and Foreign-Office Non-Local Currency Claims													Cross-Border and Foreign-Office Non-Local Currency Contingencies				Foreign-Office Local Currency Activities with Local Residents		
						Estimated Breakdown of Column (4) by Year Remaining to Maturity															
		On Banks	On Public Borrowers	On All Other Borrowers	Total	One year and Under	Over One Year to Two Years	Over Two Years to Five Years	Over Five Years	Claims On Banks Reported in Column (1) with Head Office [or Guarantor(s)] located in Another Country (s)	Redistribution of Claims on Banks, indicated in Column (9) to Country(s) of Head Office [or Guarantor(s)]	Claims Reported in columns (2) and (3) with Guarantor(s) located in Another Country(s)	Redistribution of Claims indicated in Column (11) to Country(s) of Guarantor(s)	Foreign-Office non-Local Currency Claims included in Column (4)	To Public Borrowers	To Banks and Other Non-Public Borrowers	Commitments reported in Columns (14) and (15), with Guarantor(s) located in Another Country(s)	Redistribution of Commitments indicated in Column (16) to Country(s) of Guarantor(s)	Local Currency Claims on Local Residents	Local Currency Liabilities to Local Residents	Net Due Total (Due From) Over Related Offices in Other Countries
Country (a)	Code (b)	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)	(17)	(18)	(19)	(20)
LATIN AMERICA/CARIBBEAN																					
Argentina	30104																				
Bahamas	30115																				
Barbados	30155																				
Belize	30118																				
Bermuda	30402																				
Bolivia	30201																				
British West Indies	30005																				
Brazil	30309																				
Chile	30409																				
Colombia	30503																				
Costa Rica	30509																				
Cuba	30109																				
Dominican Republic	30609																				
Ecuador	31403																				
El Salvador	31509																				
Falkland Islands	30207																				
French West Indies and French Guiana	30609																				
Grenada	30709																				
Guatemala	31209																				
Guyana	31305																				
Haiti	31403																				
Honduras	31409																				
Jamaica	31607																				
Mexico	31704																				
Netherlands Antilles	31709																				
Nicaragua	31801																				
Panama	31807																				
Paraguay	32107																				
Peru	32304																				
Surinam	32702																				
Trinidad and Tobago	32409																				
Uruguay	32603																				
Venezuela	32719																				
Other Latin America/Caribbean	30930																				
TOTAL LATIN AMERICA/CARIBBEAN	30993																				

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COUNTRY EXPOSURE REPORT
(In millions of U.S. dollars)

(Name of Reporting Institution) (Before completing this form, please read carefully the instructions and definitions for preparation of this report) As of ——— (Date)

Country (a)	Cross-Border and Foreign-Office Non-Local Currency Claims														Cross-Border and Foreign-Office Non-Local Currency Exposure					Foreign-Office Local Currency Exposure with Local Residents			
	Cash (b)	Due from Banks (c)	To Public Borrowers (d)	To All Other Borrowers (e)	Total (f)	Claims on Banks and Public Borrowers Maturing in Months:				Claims On Banks (g) and/or Public Borrowers (h) with Head Office or Parent Bank (i) located in Country of Head Office or Parent (j)	Banks in and Claims on Banks Located in Country of Head Office or Parent Bank (k)	Claims Payable in Currency (ies) of Country of Head Office or Parent Bank (l)	Banks in Countries of Claims (m) Located in Country of Head Office or Parent Bank (n)	Memorandum: Foreign-Office Local Currency Claims included in Column (m)	To Public Borrowers (o)	To Banks and Other Non-Public Borrowers (p)	Claims reported in Columns (o) and (p) Payable in Banks Located in Country (q)	Number (or #) of Banks with claims in Column (p)	Local Currency Claims on Local Residents	Local Currency Liabilities to Local Residents	Net Due To or Due From Non-Related Offices in the Country
						Due in 1 Year or Less	Due After 1 Year to 3 Years	Due After 3 Years to 5 Years	Due After 5 Years													
	(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)	(k)	(l)	(m)	(n)	(o)	(p)	(q)	(r)	(s)	(t)	(u)	(v)
AFRICA AND MIDDLE EAST																						
Afghanistan	40001																					
Algeria	40102																					
Bahrain	40214																					
Egypt	40318																					
Iran	41019																					
Iraq	41106																					
Jordan	41222																					
Libya, Socialist	41342																					
Peoples Rep.	41427																					
Kuwait	41515																					
Lebanon	41622																					
Oman	41731																					
Qatar	41822																					
Saudi Arabia	41918																					
Syria	42026																					
Turkey	42107																					
United Arab Emirates	42202																					
Yemen Arab Rep.	42321																					
Yemen, Dem.	42410																					
Other Countries																						
Total	40000																					
Memo: Total Interbank Claims	40001																					

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COUNTRY EXPOSURE REPORT

(In millions of U.S. dollars)

(Name of Reporting Institution) _____ As of _____ (Date)

(Before completing this form, please read carefully the instructions and definitions for preparation of this report)

Country	Code
(1)	(2)
ADDED	
Algeria	12105
Alaska	12202
Benin	12402
Botswana	12504
British West Africa	12510
Burundi	12606
Cameroon	12704
Cape Verde	12725
Central African Republic	12729
Chad	12802
Comoros	12910
Congo (Brazzaville)	12928
Djibouti	13102
Egypt	13161
Equatorial Guinea	13190
Ethiopia	13218
Gabon	13410
Gambia, The	13507
Ghana	13561
Guinea	13751
Guinea-Bissau	13827
Ivory Coast	13857
Kenya	13915
Lesotho	13975
Liberia	14101
Libya	14109
Madagascar	14205
Malawi	14253
Mali	14340
Mauritania	14709
Mauritius	14805
Morocco	14913
Mozambique	14930
Namibia	14939
Niger	14958
Nigeria	14975
Rwanda	15807
Rwanda	15819
Sao Tome and Principe	15838
Senegal	15951
Seychelles	15969
(Continued)	

Cross Border and Foreign Office Non-Local Currency Claims														Cross Border and Foreign Office Non-Local Currency Commitments				Foreign Office Local Currency Activities with Local Residents		
				Estimated Breakdown of Column (3) by Time Remaining to Maturity									MEMORANDUM							
To Banks	To Public Borrowers	To All Other Borrowers	Total	One Year and Under	Over One Year to Two Years	Over Two Years to Five Years	Five Years	Claims On Banks, By Area of Bank's Ultimate Country Head Office (In Specified Area) Located in Another Country (4)	Redistribution of Claims on Banks, Indicated in Column (9) of Country of Head Office to Country of Ultimate Risk (12)	Claims Reported in Columns (2) and (3) with Guarantees Issued by Another Country(s)	Redistribution of Claims Indicated in Column (11) to Country(s) of Guarantor(s)	Foreign-Office Non-Local Currency Claims Included in Column (4)	To Public Borrowers	To Banks and Other Non-Public Borrowers	Unused Amounts Reported in Column (14) and (15) with Guarantees Located in Another Country(s)	Redistribution of Guarantees Indicated in Column (16) to Country(s) of Guarantor(s)	Local Currency Claims on Local Residents	Local Currency Liabilities to Local Residents	Net Due To or Due From Foreign Offices of Other Countries
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)	(17)	(18)	(19)	(20)

COUNTRY EXPOSURE REPORT

(In millions of U.S. dollars)

As of _____ (Date)

(Name of Reporting Institution)

(Before completing this form, please read carefully the instructions and definitions for preparation of this report)

		Cross-Border and Foreign-Office Non-Local Currency Claims													Cross-Border and Foreign-Office Non-Local Currency Contingencies				Foreign-Office Local Currency Activities with Local Residents		
						Estimated Breakdown of Column (4) by Time Remaining to Maturity								MEMORANDUM							
		Dr. Banks	Dr. Public Borrowers	Dr. All Other Borrowers	Total	Due over and Under	Over One Year to Two Years	Over Two Years to Five Years	Over Five Years	Claims Dr. Banks, Reported in Column (1), with Head Office [or Guarantor(s)] located in Another Country (ies)	Redistribution of Claims on Banks indicated in Column (5), to Country(s) of Head Office [or Guarantor (s)]	Claims, Reported in columns (2) and (3), with Guarantor(s) located in Another Country(s)	Redistribution of Claims indicated in Column (11) to Country(s) of Guarantor(s)	Foreign-Office non-Local Currency Claims included in Column (4)	To Public Borrowers	To Banks and Other Non-Public Borrowers	Commitments reported in Columns(14) and (15), with Guarantor(s) located in Another Country(s)	Redistribution of Commitments indicated in Column (16) to Country(s) of Guarantor(s)	Local Currency Claims on Local Residents	Local Currency Liabilities to Local Residents	Net Due To or (Due From) Head Office(s) in Other Countries
Country (a)	Code (b)	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)	(17)	(18)	(19)	(20)
AFRICA (Continued)																					
Sierra Leone	53549																				
Somalia	53823																				
South Africa	53715																				
Southern Rhodesia	54704																				
Spanish Sahara	54939																				
Sudan	55103																				
Swaziland	55219																				
Tanzania	56485																				
Togo	56502																				
Tunisia	56703																				
Uganda	56904																				
Upper Volta	57116																				
Zaire	51505																				
Zambia	51707																				
Other Africa	58594																				
TOTAL AFRICA	52594																				
OTHER COUNTRIES																					
Australia	60245																				
British Guyana	60728																				
Fiji	60907																				
French Polynesia	60734																				
Malaya	61301																				
New Caledonia	61488																				
New Zealand	61589																				
Papua New Guinea	61751																				
St. Pierre and Miquelon	62719																				
Tonga	63148																				
U.S. Trust Territories and Pacific Islands	63502																				
Western Samoa	63618																				
All Other Countries	59999																				
TOTAL OTHER COUNTRIES	59936																				

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COUNTRY EXPOSURE REPORT

(In millions of U.S. dollars)

As of _____ (Date)

(Name of Reporting Institution)

(Before completing this form, please read carefully the instructions and definitions for preparation of this report)

Country (a)	Code (b)	Cross-Border and Foreign-Office Non-Local Currency Claims													Cross-Border and Foreign-Office Non-Local Currency Contingencies				Foreign-Office Local Currency Amounts with Local Residents		Memo Item
		(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)	(17)	(18)	(19)	(20)
Canada																					
United States (C)		XXXX	XXXX	XXXX	XXXX	XXXX	XXXX	XXXX	XXXX					XXXX	XXXX	XXXX			XXXX	XXXX	XXXX
TOTAL NORTH AMERICA																					
INTERNATIONAL AND REGIONAL																					
International		XXXX		XXXX																	
Western European Regional		XXXX		XXXX																	
Central European Regional		XXXX		XXXX																	
Latin American Regional		XXXX		XXXX																	
Asian Regional		XXXX		XXXX																	
African Regional		XXXX		XXXX																	
Middle Eastern Regional		XXXX		XXXX																	
TOTAL INTERNATIONAL AND REGIONAL		XXXX		XXXX																	
GRAND TOTAL (D) (E)																					

Chairman NEAL. I would like to welcome our witnesses this morning, and I would like to ask you to please submit your entire statements for the record. They will be, without objection, inserted. And please feel free to summarize as you wish, so that we might have a little more time for the question and answer session.

If it is all right with the witnesses, we will proceed in the order in which I read the names, that is, Mr. Heller, Mr. Vagliano, and Mr. Balatsos. Mr. Heller, we would like to hear from you first.

STATEMENT OF H. ROBERT HELLER, VICE PRESIDENT FOR INTERNATIONAL ECONOMICS, BANK OF AMERICA

Mr. HELLER. Thank you very much, Mr. Chairman. It is a pleasure to appear before the subcommittee to testify on the role of commercial banks in the OPEC recycling surplus process and the desirability of a quota increase for the IMF——

Chairman NEAL. Excuse me. I didn't think to ask my colleagues if they had any opening statements.

[No response.]

Chairman NEAL. Please proceed. I am sorry.

Mr. HELLER. As requested in the letter by the chairman, I would like to concentrate on the role of commercial banks in this particular process and also explore areas of increased possible cooperation between the Fund and the banks. Before turning to these specifics, permit me to provide a general view of the ability of the international financial system to cope with the challenges before us.

The second substantial oil price increase in the short period of 6 years confronts the world economy with an unprecedented adjustment problem, and the structural changes that are needed in response to this price increase are vast. They have already taxed the resiliency and adaptability of the world economy to the limit and will continue to do so.

And there is no question that further oil price increases would lead to widespread economic difficulties, an exacerbation of international tensions, and possibly more serious consequences. In particular, the development prospects of the oil importing countries would be seriously jeopardized.

The massive transfer of wealth attendant to the shift in purchasing power from the oil importing countries to the oil exporting countries will also strain the international financial system for years to come. And while, as the chairman pointed out, the process of financing the deficits of the oil importing countries subsequent to the 1974 increase was accomplished with a remarkable degree of ease, the question has been raised whether the international financial system, and in particular the commercial banks, can again be expected to recycle the OPEC surplus in a smooth fashion.

It may be useful to provide some very brief perspective on the magnitude of the international payments balances financed by comparing them to the size of the world economy, international financial markets and official reserves. In 1974 the OPEC surplus of $68 billion amounted to 1.6 percent of the GNP of the free world. While now the $100 billion surplus expected for 1980 is equivalent to 1.3 percent of the free world GNP, indicating a very slight decrease in the real burden to be carried.

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Similarly, if you compare the size of the OPEC surplus to the magnitude of the Euromarket, which will again have to carry very much of the recycling burden, one comes to the conclusion that the effort required will be somewhat less than in 1974. At that time, the OPEC surplus amounted to approximately 18 percent of the gross size of the Euromarket, while now the surplus will be considerably less than 10 percent of the Euromarket, which has grown now to over $1 trillion.

One may also compare the size of the OPEC surplus to the size of the official reserves that are available to finance the imbalances faced by the world economy. In 1974 the OPEC surplus amounted to 40 percent of the international reserve holdings of $173 billion, excluding gold holdings, while now it amounts to approximately 25 percent of international reserves.

Of course, the ultimate financial question is whether the debt burdens assumed by the oil importing countries can be serviced properly. If the OPEC surplus funds are utilized for productive purposes, then there is little reason to assume that the debt burdens will become unbearable.

Under such circumstances, the recycling process will not only be manageable, but it will also lead to the ultimate elimination of the imbalances that generated the problem in the first place by enhancing the export earning capacity of the oil importing countries.

This adjustment problem really represents the key issue confronting the world economy. There are no fundamental weaknesses in the international financial system as such that would prevent a recycling of the OPEC surplus. Of course, let me add the caveat that the success of the recycling operation will also hinge on the absence of additional disturbances, such as further oil price increases, very high inflation rates in the world economy, the maintenance of an open international trading system, and the pursuit of well designed adjustment policies.

Let me now turn to the role that commercial banks can be expected to play in lending to the developing countries. In answering the chairman's questions, I will particularly focus on the activities of Bank of America in that process. As is well known, any lending decision is based on a complex set of considerations, but three fundamentals will always play a crucial role: return, risk, and diversification.

Bank of America's average interest rate earned on its total foreign loan portfolio has been very much in line with that obtained on domestic loans. For instance, in 1979 the average rate of interest earned on domestic loans was 11.53 percent. But it was 11.98 percent for foreign loans, resulting in a slight advantage for foreign loans.

Of course, the absolute level of interest rates is not particularly meaningful if viewed in isolation, and must therefore be seen in relation to the risk as reflected in loan losses, to interest expenses incurred in funding operations, and to other business expenses such as personnel, premises and the like.

In 1979 the loan loss experience in foreign operations was roughly comparable to domestic operations, and that particular trend has also been true in years past. However, the cost of funds was markedly higher abroad than it was in the United States. On

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balance, therefore, domestic operations were slightly more profitable than foreign operations for the bank.

Of course, the question remains whether any special factors were operative with respect to loans to developing countries as opposed to the general experience with loans to foreign countries. Here I have provided you some detailed data on page 7, table 1, regarding Bank of America's total foreign loans and security holdings. These data show that total outstandings to developing countries of $8.3 billion at the end of 1979 were 10.2 percent above the level in 1978, which in turn was 21 percent above 1977.

While these data show that Bank of America has been very active in its lending to developing countries, the syndicated loan market does not at the present time offer a very attractive vehicle for such lending. As recently as 1976, spreads charged for loans to developing countries averaged around 2 percentage points, while now spreads average less than 1 percentage point, with spreads of one-half of 1 percent not unheard of.

But there are several reasons to expect that these spreads will increase in the near future:

For one, newcomer banks attempting to penetrate markets have largely achieved their objectives.

Second, the regulatory agencies are very closely monitoring international activities of commercial banks and consolidated worldwide reporting is going to be introduced in several major countries.

Third, Japanese banks in particular have greatly scaled back their expansion plans.

Fourth, international bond markets are not likely to be very active in the future, paralleling the trends in domestic bond markets, and hence greater reliance will have to be placed on bank financing.

Fifth, it is unlikely that banks will bid aggressively for OPEC deposits, as they have already a considerable liability exposure to these countries as well.

All these factors therefore point in the same direction: the return to more reasonable interest rate spreads in international lending that would offer an adequate compensation for the risks assumed by the banks.

In that whole lending process, the evaluation of country risk plays an important part and it should be stressed, therefore, that the Bank does have an elaborate internal system to set formal country limits and to monitor and control that country exposure. But the exposure to any one country has to be seen in the context of the overall portfolio. Much more than the setting of individual lending limits is involved here, because diversification among countries and industries and commodities, as well as other factors, play an important role in that process.

As the overall portfolio grows, there will also be further scope for lending to the developing countries. A key question is whether the banks will have adequate capital to undertake that additional business. It is especially in that arena that the effects of inflation are severely felt. Higher interest spreads are therefore crucial, because they will be needed to provide the necessary rate of return on capital that will attract new capital funds into the banking industry.

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Given today's high interest rates, it is difficult indeed to attract fresh capital, because new equity issues will have to compete with high-yielding alternatives. The importance of internally generated funds can therefore not be overemphasized.

In that connection, let me also turn to the chairman's question on the effects of the Federal Reserve and the stiff credit restraint program. I would argue that it will make the international arena relatively more attractive for U.S. banks. The main reason for this is that the 6 to 9 percent ceiling on domestic credit growth will constrain domestic lending activity. If additional growth is to be achieved, it will therefore have to come in the form of international activity.

It should also be noted that this additional foreign lending will not be funded from domestic sources, but largely from the OPEC surplus funds available for recycling.

I have argued that if the incentives are appropriate the commercial banks will continue to play a major role in the recycling process. But looking at alternative channels, it is clear that one important channel for international financial flows that needs revitalization is the international bond market. Bond financing of some of the current account deficits of the developing countries would be desirable because it will not impinge on the capital ratios of commercial banks. Instead, the lending risk is placed on the ultimate provider of funds, in this case the OPEC surplus countries.

Commercial and investment banks can play a useful role in managing these international bond issues and by providing expertise and investment advice to international lenders.

Second, more international equity investments are also called for. Equity investments have the advantage that they do not obligate the country where the investment is made to maintain a fixed interest payment stream. Another advantage is that equity investments insure that the funds are spent in a productive manner, also bringing technological know-how to these countries and thereby enhancing the earnings capacity of a country where the investment is made.

In that connection, it may be advisable to explore the possibility of founding an international investment bank to channel investment funds from the surplus countries to the developing countries. The surplus countries would obtain the management expertise and supervision of the investment activities, and an international body in that particular area would make the investments less objectionable to the host countries than direct foreign investments by another country.

Turning to the International Monetary Fund's dual role in the international arena, we see, first of all, the Fund as an important forum to foster the international adjustment process.

Second, it is a provider of financial resources to ease temporary balance of payments difficulties. In the past, the IMF has relied heavily on quota subscriptions to obtain the financial resources necessary for this financing role. For this reason, the proposed increase in the IMF quota would serve a highly desirable stabilizing influence in the world financial system.

But the Fund has also relied in the past on direct borrowings from capital surplus countries through the oil facilities and the so-

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called Witteveen facility. Such direct borrowing from member countries is a desirable alternative way of recycling the surplus funds to the debtor countries.

If necessary, direct borrowing from countries can be supplemented through borrowings by the IMF from the commercial banking system as well. This will enable the OPEC surplus countries to hold short-term bank deposits and accommodate the desire of the banks to avoid excessive country exposure to any individual country. At the same time, the financial resources available to the IMF are enhanced.

It would also be possible for the IMF to greatly increase the leverage that it gets out of its own financial resources by utilizing them to guarantee bank loans to developing countries, by not directly committing the resources at its disposal, but instead utilizing them as a form of insurance fund. The total amount of resources that would be made available to the developing countries under IMF auspices would be greatly increased and the cost to the developing countries would be lower. Such an arrangement could be similar to the current Eximbank practices.

As part of the surveillance process, the IMF may also want to take more of a view toward the debt carrying capacity of its member countries, even if these countries do not at the present time have standby arrangements with the Fund.

The Fund may also consider closer cooperation with the commercial banks in the international lending area. Here, for instance, the establishment of a liaison office with commercial banks could provide a useful forum for discussions with commercial banks in situations where standby arrangements are being negotiated and commercial banks might make certain lending commitments subject to the implementation of that standby agreement.

Second, the liaison office could also serve as an information center for commercial banks, making available perhaps the reports on recent economic developments to commercial banks. Such an activity would be particularly useful for the smaller and medium-sized commercial banks, who cannot maintain their own extensive international network. By making better information available to these banks, the total amount of lending to developing countries would be increased because new banks would be brought into that particular process.

In conclusion, let me reiterate that while the world economy is faced with a serious challenge indeed, there is good reason to believe that the international financial system will not be the cause of a major breakdown. It is clear that a strong and resilient international financial system is both in the national interest of the United States and in the interest of the community of nations.

Commercial banks are ready to play a constructive role in maintaining and fostering such a healthy international financial atmosphere. But every effort should also be made to enhance the overall stability of the system.

Because the IMF plays such a central role in the international monetary system, we would like to urge you strongly to support H.R. 5970, which authorizes an increase in the quota of the United States in the International Monetary Fund.

Thank you very much.

[Mr. Heller's prepared statement follows:]

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Statement

on

International Commercial Bank Lending and the Desirability of an IMF Quota Increase

by

H. Robert Heller
Vice President for International Economics
Bank of America NT&SA
San Francisco, California

before the

Subcommittee on International Trade, Investment and Monetary Policy
of the
Committee on Banking, Finance and Urban Affairs
U. S. House of Representatives

Washington, D.C.

April 21, 1980

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It is a pleasure to appear before the Subcommittee to testify on the role of commercial banks in the OPEC surplus recycling process and on the desirability of a quota increase for the International Monetary Fund.

As requested in the letter by the Chairman, I will concentrate on the role that commercial banks might be expected to play in this process, and explore areas for possible increased cooperation between the Fund and the banks. But before turning to these specifics, permit me to provide a general view of the ability of the international financial system to cope with the challenges before us.

The World Economy, the International Financial System, and the Oil Price Increase

The second substantial oil price increase in the short period of six years confronts the world economy with an unprecedented adjustment problem. The structural changes that need to be undertaken in response to this price increase are vast. They have taxed the resiliency and adaptability of the world economy to the limit and will continue to do so. There is little question that further oil price increases would lead to widespread economic difficulties, an exacerbation of international tensions, and possibly more serious consequences. In particular, the development prospects of the oil-importing developing countries would be seriously jeopardized.

The massive transfer of wealth attendant to the shift in purchasing power from the oil-importing countries to the oil-exporting countries will also strain the international financial system for years to come. While the process of financing the deficits of the oil importing countries subsequent to the 1974 oil price increase was accomplished with a remarkable

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degree of ease, the question has been raised whether the international financial system and in particular the commercial banks can again be expected to finance the OPEC surplus in a smooth fashion. It may therefore be useful to provide some perspective on the magnitude of the international payments imbalances to be financed by comparing them to the size of the world economy, international financial markets, and official reserves.

The 1974 OPEC surplus of $68 billion amounted to 1.6 percent of the GNP of the free world. The $100 billion OPEC surplus expected for 1980 is equivalent to 1.3 percent of the free world GNP, indicating a slight decrease in the relative burden to be carried.

Similarly, if one compares the size of the OPEC surplus to the magnitude of the Euromarkets which will again have to carry much of the recycling burden, one comes to the conclusion that the relative effort required in 1980 will be less than in 1974. In 1974 the total OPEC surplus of $68 billion amounted to 18 percent of the gross size of the Euromarkets of $375 billion, while the $100 billion OPEC surplus of 1980 will be considerably less than 10 percent of a Euromarket that has grown to over $1 trillion by now. In terms of financial market size, the current OPEC recycling demands will therefore be smaller than in 1974.

One may also compare the OPEC surplus to the official resources that are available to finance the imbalances faced by the world. The 1974 OPEC surplus amounted to 40 percent of official international reserve holdings of $173 billion (excluding gold). The 1980 surplus of $100 billion will amount to only 25 percent of official reserves. Of course, the inclusion of gold valued at market prices in these comparisons would strengthen the argument further.

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Even looking at the non-oil developing countries in isolation, one comes to similar conclusions: in 1974 these countries had $32 billion in foreign exchange reserves, or slightly more than their current account deficit of $30 billion. Now they have $77 billion in foreign exchange reserves and a projected deficit of $60 billion, leaving a somewhat greater cushion.

The ultimate question is whether the debt burdens assumed by the deficit countries can be serviced properly. If the OPEC surplus funds are utilized for productive purposes, there is no reason to assume that debt burdens will become unbearable.

While it is true that debt service payments of the non-OPEC developing countries expressed as a percentage of their exports of goods and services have increased from the 8 - 9 percent range in 1974 to 13 percent in 1979, it should be borne in mind that broad generalizations in this area are hazardous at best. Not only is a country-by-country analysis needed, but it is necessary to determine for what purpose the debt is incurred. Obviously, there is a significant difference between using external funds to construct a new hydropower facility that reduces the dependence on future oil imports and the ulitization of external financing to pay for imported gasoline destined for pleasure driving. Debt burdens are therefore not particularly meaningful in an absolute sense, but only as they relate to the debt servicing capacity of the individual countries.

The important task faced by the international financial system is to channel the OPEC surplus funds into their most productive use. If undertaken properly, the recycling process will not only be manageable, but will

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lead to the ultimate elimination of the imbalances that generated the problem in the first place by enhancing the export-earning capacity of the oil-importing countries.

The adjustment problem represents the key issue confronting the world economy. There are no fundamental weaknesses in the international financial system that would prevent a recycling of the OPEC surplus. Of course, the success of the recycling operation will hinge on the absence of additional disturbances, such as further oil price increases above the inflation rate or a major unexpected recession in the industrial countries, the maintenance of an open international trading system, and the pursuit of carefully designed adjustment policies.

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Bank Lending to Developing Countries

Let me now turn to the role that commerical banks can be expected to play in lending to the developing countries. In answering the chairman's questions on that topic I will particularly focus on the activities of the Bank of America.

Any lending decision is based on a complex set of considerations, but three fundamentals will always play a crucial role: return, risk, and diversification.

Bank of America's average interest rate earned on foreign loans has been very much in line with that obtained on domestic loans. For instance, in 1979 the average rate of interest earned on domestic loans was 11.53 percent, while it was 11.98 percent for foreign loans, resulting in a 40 basis point advantage for foreign loans.

Of course, the absolute level of interest rates earned is not particularly meaningful if viewed in isolation and must be seen in relation to risk as reflected in loan losses, interest expenses incurred in funding operations, and other business expenses such as personnel, premises, and the like. In 1979 the cost of funds abroad was markedly higher than in the U.S., while the loan-loss experience was roughly comparable.

On balance, domestic operations viewed as an aggregate were therefore slightly more profitable than foreign operations. Of course, all sufficiently profitable business opportunities are lucrative and worth pursuing. It can therefore be expected that Bank of America will continue to seek out attractive business both at home and abroad.

The question remains whether there were any special factors operative with respect to loans to developing countries as opposed to the

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general experience with foreign loans. Table 1 provides some detail regarding Bank of America's total foreign loans and security holdings. These data show total outstandings to developing countries of $8.3 billion at the end of 1979, which was 10.2 percent above the $7.5 billion in outstandings at the end of 1978. In 1978 outstandings had grown by 21.6 percent over 1977.

While these data show that Bank of America has been very active in its lending to developing countries, the syndicated loan market does not offer at the present time a very attractive vehicle for such lending. As recently as 1976, spreads charged for loans to developing countries averaged around 2 percentage points, while spreads now average less than 1 percent with spreads of one-half of one percent not unheard of.

In that connection it may be worth pointing out that the slowdown in the pace of expansion abroad during the last few years was not so much due to an increase in perceived risk, but in lower profitability especially as compared to domestic operations.

There are several reasons to expect that spreads will tend to increase in the near future. For one, newcomer banks attempting to penetrate markets have largely achieved their objectives. Banks are unlikely to be highly aggressive in seeking out new lending opportuntities. Two, regulatory agencies are monitoring the international activities of commercial banks much more closely. Consolidated world-wide reporting requirements are about to be introduced in a number of countries, dampening the enthusiasm for foreign expansion. Three, the Japanese banks in particular have greatly scaled back their expansion plans, largely in response to Ministry of Finance requests. Four, international bond markets are unlikely to be very active in the near future, paralleling the trends

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Table I

Total Loans and Securities - Non-U.S. Borrowers by Domicile of Borrower at Year End
(In millions of U.S. dollar equivalents)

	1979	1978	Currency of Borrower's	Currencies Foreign to Borrower's Country of Residence, 1979		
	Total Loans and Securities	Total Loans and Securities	Country 1979	Total	Under 1 Year	Over 1 Year
Industrialized Countries	$11,618	$11,276	$6,703	$4,915	$2,480	$2,435
Centrally Planned Countries	846	665	0	846	676	170
Oil Exporting (OPEC) Countries	2,064	2,593	204	1,860	1.189	671
Developing Countries:						
High Income	551	442	233	318	202	116
Upper Middle Income	3,101	2,691	562	2,539	1,424	1,115
Intermediate Middle Income	2,954	2,825	367	2,587	1,029	1,558
Lower Middle Income	1,250	1,212	411	839	394	445
Low Income	420	341	180	240	153	87
Total	$22,804	$22,045	$8,660	$14,144	$7,547	$6,597

Centrally Planned Countries and Developing Countries are classified according to World Bank definitions as of 1979. Classification is based upon per capita income.

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in domestic bond markets. Hence, greater reliance will be based on bank financing. Five, it is unlikely that banks will bid aggressively for OPEC deposits as they have already a considerable liability exposure to these countries. All these factors point in the same direction: the return to more reasonable interest spreads in international lending that would offer adequate compensation for the risks assumed by the banks.

The evaluation of country risk plays an important part in all foreign lending decisions. For that reason, the bank systematically evaluates economic and political country risk through a process that involves officers stationed in the different countries around the globe, various groups of economists, and senior headquarters staff. The process culminates in a country rating which is then used as an input into the setting of the bank's country limits and the management of the total portfolio.

One point should be stressed: while the bank does have an elaborate internal system to set formal country limits and to monitor and control country exposure, the exposure to any one country must be seen in the context of the overall portfolio. Much more than the setting of individual country limits is involved here, and diversification among countries and industries as well as other factors play an important role. As the overall portfolio grows, there will also be further scope for lending to the developing countries.

Overall portfolio management and control provides a most important protection against possible adverse developments. While it is difficult to form a global view of total risk incurred, it is probably

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fair to state that the perceived risk has increased somewhat during the last year, but that it remains well within manageable limits.

A key question is whether the banks will have adequate capital to undertake the additional business. It is especially in this area that the effects of inflation are severely felt. While inflation causes loan demands to increase, it does not automatically enhance the capital base.

Higher interest spreads are therefore crucial because they will be needed to provide the necessary rates of return on capital that will attract new capital into the banking industry. But given today's high interest rates, it will be difficult indeed to attract fresh capital funds because new equity issues will have to compete with high yielding alternatives.

The importance of internally generated funds can therefore not be over-emphasized. This implies that a strong performance now is the precondition for future growth. In such an environment the strong are likely to gather further strength, while the weak will have difficulty to generate the funds needed to keep pace. This also implies that there is no reason why strong and well managed banks should not be in a position to expand and to accommodate the needs of creditworthy international borrowers.

In the late seventies, some interesting patterns in the capital ratio of international banks as measured by the relationship between shareholders' equity and total assets emerged. The publicly available data show that many Japanese and German banks suffered deteriorations in the capital ratio between 1976 and 1978, while Swiss, Canadian, and British banks improved theirs. U.S. banks offer a more mixed picture. It stands to reason that those banks that improved their capital ratios are

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now in a better position to take advantage of international banking opportunities as they present themselves.

In that connection the Federal Reserve's domestic credit constraint program is also likely to have some impact on foreign lending activity. While the higher interest rates attendant to the program of monetary restraint will have a dampening effect on global economic activity, the domestic credit restraint program is likely to make the international arena relatively more attractive for U.S. banks. The main reason for this is that the 6 to 9 percent ceiling on domestic credit growth will restrain domestic lending activity. If additional growth is to be achieved, it will therefore have to come in the international sector. It should be noted that this additional foreign lending activity will be funded not from domestic sources, but largely from the OPEC surplus funds available.

These tendencies would probably have manifested themselves even in the absence of the domestic credit restraint program because domestic loan demand would have decelerated as U.S. economic growth slowed down. American banks are therefore in a good position to resume international lending, provided the profit incentives are appropriate.

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Alternative Channels for Recycling the OPEC Surplus and the Role of the IMF

I have argued that, if the incentives are appropriate, the commercial banks will continue to play a major role in the recycling process. In that connection it should also be recognized that Arab banks have greatly expanded their international activities. Several new Arab banks have been formed, and their international business is expanding rapidly.

One channel for international financial flows that needs revitalization is the international bond market. Similar to domestic bond markets, the international bond market is languishing at the present time. In a high inflation world environment it will probably take major innovations, such as the introduction of floating interest rate bonds, to restore the market. Bond financing of some of the current account deficit of the developing countries would be desirable because it would not impinge on the capital ratios of commercial banks. Instead, the lending risk would be placed upon the ultimate provider of funds--in this case the OPEC surplus countries. Commercial and investment banks can play a useful role in managing these international bond issues and by providing expertise and investment advice to international lenders.

More international equity investments are also called for. Equity investments have the advantage that they do not obligate the country where the investment is made to maintain a fixed interest payment stream. Instead, the payment stream is directly related to the profitability of the investment. Another advantage is that equity investments ensure

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that the funds are spent in a productive manner, thereby enhancing the earnings capacity of the country where the investment is made. In contrast, loans can be made for investment or consumption purposes.

In that connection, it may also be advisable to explore the possibility of founding a new international investment bank. Such an international institution could be used to channel investment funds from the surplus countries to the developing countries. The surplus countries would obtain the management expertise and supervision of the international investment bank, thereby freeing the investors from these difficult tasks. At the same time an international institution supervising the investments may be less objectionable to the host countries than direct foreign investments by another country.

Turning to the International Monetary Fund's role in the international financial arena, it is evident that this institution occupies a central place in the international monetary system. By fulfilling two important functions, the International Monetary Fund is vital to the soundness of the international monetary system. The first important function of the Fund is to foster adjustment on behalf of the member countries to disturbances. Its second function is to provide financial resources to ease temporary balance of payments difficulties and thereby make the adjustment process smoother. In the past the IMF has relied heavily on quota subscriptions to obtain the financial resources necessary for its financing role. IMF quotas have merely doubled since 1966, while the volume of world trade has increased by 800 percent. IMF quotas amount now to only 15 percent of official foreign exchange reserves and less than 5 percent of the size of the Eurocurrency market. Consequently,

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the IMF's resources are rather modest in comparison to funds available through other channels. If countries are to be induced to undertake IMF supervised adjustment programs, it is necessary to provide sufficient financial resources, and thereby incentives, to induce them to enter into a standby agreement with the IMF. It goes without saying that in the absence of such adjustment programs and IMF lending exchange rate fluctuations will be wider and quotas and other restraints on trade will be greater. For all these reasons the proposed increase in IMF quota would serve as a highly desirable stabilizing influence on the world financial system in these difficult times.

The IMF has in the past also engaged in direct borrowing from capital surplus countries through the oil facilities and the so-called Witteveen facility. Such direct borrowing from member countries is a desirable alternative way of recycling surplus funds to the debtor countries. If necessary, direct borrowing from countries can be supplemented through borrowings by the IMF from the commercial banking system. Of course, such funds are likely to be more expensive than those obtained directly from governments. But if the OPEC surplus countries should continue to show a preference for short-term bank deposits, it might make sense to utilize both the commercial banking system and the IMF as intermediaries in the recycling process. As a result both the desire of the OPEC countries to hold short-term bank deposits and the desire of the banks to avoid excessive country exposure to any individual country could be fulfilled. At the same time the financial resources of the IMF would be increased, thereby encouraging countries to undertake adjustment measures as suggested by the Fund. The cost to the borrowing countries should not differ substantially from those incurred by direct bank borrowing.

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It would also be possible for the IMF to increase the leverage that it gets out of its own financial resources by utilizing them to guarantee bank loans to developing countries. By not directly committing the resources at its disposal but instead utilizing them in the form of an insurance fund, the total amount of resources that would be made available to developing countries under IMF auspices could be greatly increased. Such an arrangement could have similar characteristics to Ex-Im Bank practices. Of course, such an operation might require a change in the IMF Articles if carried out through the General Account, but might well be feasible now under the Trust Account.

The second amendment of the Articles of Agreement of the International Monetary Fund gave that institution the obligation to oversee the international monetary system in order to ensure its effective operation and the compliance of member countries with the obligation to promote stability by fostering underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions. As part of this surveillance exercise the IMF might well take a view towards the debt carrying capacity of its member countries, even if these countries do not at the present time have a standby arrangement with the IMF. While external borrowing limitations are frequently imposed as part of standby arrangements, the Fund has refrained from making statements on the debt servicing capacity of its member countries in situations where no such standby agreements were in effect. To safeguard the stability of the international monetary system the Fund might consider taking a more active role in this field.

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The Fund might also consider closer cooperation with the commercial banks in the international lending area. In particular, it may be useful to establish a liaison office for commercial bank relations within the International Monetary Fund. Such a liaison office could serve two main functions: first of all, it could provide a forum for discussions with commercial banks. Such a discussion forum would be particularly helpful in situations where a standby arrangement is being negotiated and commercial banks might make certain lending commitments subject to the implementation of the standby agreement. Second, the liaison office could serve as an information center for commercial banks. It would be highly desirable for the IMF to make public its reports on recent economic developments in the member countries. The wealth of information accumulated in these reports is substantial and no use is made of these reports outside official circles. There is little confidential information contained in these reports, and they could be readily purged of any such information. Of course, the staff recommendations regarding the policies of the member country should remain confidential because they represent the IMF's advice to the country. The establishment of such a liaison office would be particularly helpful for the smaller commercial banks that do not have the resources to maintain a research and information gathering staff. By making better information publicly available the group of banks that would be in a position to lend to developing countries would be considerably broadened, thereby increasing the resources available to the developing countries.

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Conclusions

In conclusion, let me reiterate that while the world economy is faced with a serious challenge, there is good reason to believe that the international financial system will not be the cause of a major breakdown.

Bank of America as part of the international commercial banking system is ready to play a constructive role in maintaining and fostering a healthy international financial atmosphere, and any suggestions you might have toward furthering that goal would be appreciated.

It is clear that a strong and resilient international financial system is in the national interest of the United States and in the interest of the community of nations. Every effort should be made to enhance the stability of the system. The IMF plays a central role in the international monetary system and we therefore urge you strongly to support H.R. 5970 which authorizes an increase in the quota of the United States in the International Monetary Fund.

Chairman NEAL. Mr. Heller, thank you very much.
Now, Mr. Vagliano, we would like to hear from you.

STATEMENT OF ALEXANDER M. VAGLIANO, EXECUTIVE VICE PRESIDENT, INTERNATIONAL DIVISION, MORGAN GUARANTY TRUST CO.

Mr. VAGLIANO. Mr. Chairman, we did not prepare a statement. I thought I could respond to these questions.

I will give you a little background on myself. I am head of the international division of Morgan Guaranty and responsible for the management of our international business. I had the pleasure of spending 4 years here in Washington in 1961 to 1965 in the Agency for International Development, where I was responsible for the development lending program for the Near East and South Asia.

In response to these questions, I think it is fair to say that we are going through a difficult time, and I would expect that it will continue in light of the dislocations to the different types of economies—developed, less developed, industrial and agricultural—from these enormous increases in the price of energy.

And in the final analysis, of course, it comes down to basic adjustments. The United States is going to have to adjust, Europe is, Japan is, as well as the LDC's. We are going to be going through difficult periods. We are going to be going through perhaps at times dangerous periods.

I think the role of the IMF as well as the role of the banks, the role of the World Bank, the role of new OPEC institutions, if everybody works together with a reasonable amount of intelligence—I think it has been demonstrated in the last few years that

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the financial systems of the world, the governments, the reactions of governments, are able to cope with difficult challenges.

As far as the specific questions are concerned, the first one had to do with the constraint on U.S. banks over the next few years. Well, it mentions that the share of U.S. banks in international lending has contracted since 1977. I think perhaps that is putting the emphasis a little bit wrong in the sense of what has happened since 1977. I think it has been a desirable thing that you have a lot more financial participants from Europe, from Japan and Canada, and even from some of the LDC's, whose financial institutions are now becoming more global.

So I think you do have more players in this. There is in terms of the overall constraint naturally a response by the banks of any country to other demands on their funds due to their own priorities, if you wish, with respect to customers in their own country. So you have variances from time to time. You also have government attitudes which play a greater or lesser role, depending on the countries. You have, as Mr. Heller mentioned, the elements, of course, of risk and return.

Risk is a difficult thing to discuss because risk is different, even if you are talking about the same country. It may be the nature of the financial operation, the length of duration of it, the purpose, all are factors that go into risk, and these are changing elements.

The question of return—and I would like to dwell on that just for a moment. The structure of the bulk of international lending by the banks has been on a floating rate basis in which the cost to the borrower is a reflection of a margin over the cost to the banks. So if, for example, the interbank rate, which is usually set in London, is 8 percent or 12 percent or 16 percent, the borrower will pay an additional percentage, which may be as low as a quarter, three-eighths, or a half. Several years ago the margins got up as high as 1¼ or 1½, even 2 percent.

At the present level of interest rates, of course, the margin that is taken by the banks is proportionately very small. And while a great deal of attention is paid to these margins, one additional cause of concern to the energy-importing LDC's is, of course, the high level of interest costs which it takes under present interest rates to service their debt.

It shows the interrelationship of all these matters, international and national. It is, of course, a fact that our program here to cope with our own economic problem of inflation has had a direct impact in raising the interest cost and hence the debt burden of the LDC's.

The bank margins—I have spoken on this a great deal over the last couple of years. I think often the bank margins have been on the low side in the sense of, as Mr. Heller referred, the relationship to noninterest costs, such as premises and personnel, which are the principal ones in a bank over a period of years. Particularly for long commitments, 6, 8, 10 years—some of the spreads of a half, five-eighths, or three quarters, which we have seen during the last year and a half have been really not adequate. And I think we may be seeing some change in this.

The result has been that several banks, including our own, have stayed out of transactions which we thought would be perfectly

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creditworthy, but we wanted to limit the overall amount of our assets bearing this kind of return.

As far as the second question, which refers to whether or not we expect to reach our limit on lending to any of the largest LDC borrowers over the next few years, I don't think it is a question really answerable in a general sense, because we are constantly making decisions whether to lend or not to lend, depending upon the particular transaction, how we feel the country is doing at a particular time, how they are managing their economy and, of course, how they are proceeding to adjust to various problems. Are they developing an intelligent energy policy is one thing that we are looking at, but more closely than we did, of course, 10 years ago. But it is really the whole approach of a country to managing its resources, not only economic resources, but human resources, and its responsiveness to change, the ability to have the country adapt and react properly to the unexpected.

So, as I say, we are all living with a great number of unexpectednesses, and it is a question of how we react to them.

The question about U.S. monetary policy: As Mr. Heller said, it is correct that the restrictions do not affect loans to the LDC's. To that extent, one could suppose that there would continue to be adequate availability. And I think that is correct. I do think, however, even when you do have the circumstance of tightness, it does tend to affect attitudes. The various concerns of our own government, the Bank for International Settlements, the European-Japanese and other monetary authorities have had the impact, I would say, of making bank managements pay particular attention to the various considerations that I have referred to.

Mind you, I think, Mr. Chairman, it is a good thing. It is a dangerous world. But I think if people are careful and imaginative, we can get through it.

That leads to the fourth question, a very interesting one, which is: Will it be possible to recycle a larger share of the OPEC surplus through alternative channels?

Of course, one of the interesting and important alternate channels is for the OPEC countries to do a good deal more in this directly themselves. I would hope they would do more.

You have some institutional problems which I think are in better shape than they were 4 or 5 years ago, in the sense that many of the OPEC countries have developed skills, have developed staffs, have developed accounting systems, have set up development funds, have set up, in fact, a much broader infrastructure for that kind of direct lending by them to the LDC's.

I think they recognize a responsibility—many of them recognize the responsibility. And I think that perhaps that recognition has been impeded at times by just institutional weaknesses.

While by no means do I think that everything is in place, I think there is a better structure if there is a will on their part to do more lending themselves, which means taking more risks themselves.

I am afraid it is a fact that once you get rich, as they have gotten rich, they have to take more risks. That is part of the baggage of being rich. And I think more and more they should come to that realization.

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The next question has to do with whether the less developed among the non-OPEC countries will have to accept a major share of this net increase in international indebtedness. I am not sure that that is necessarily right.

I think that the general increase in lending to LDC's has tended to parallel other countries. It is true that the LDC's have a particularly sharp problem over the next few years.

A factor that ties in very closely and which is extremely important is that the industrial countries be willing to share the deficit. And by that I mean that if all of the developed countries, industrial countries, take similar and eventually protectionist steps to redress their own balance-of-payments deficit caused by the increase in petroleum prices, and if they are successful at this, and if at the same time the policies followed lead to a concurrent recession, that that would be extremely damaging to the LDC's.

In other words, what I am saying is that we are going through a period of imbalance. We have seen the figures on the amount of the OPEC surpluses, which go up to $70, $80, $90 billion.

If the industrial countries were all successful in pushing the entire amount of that net deficit onto the LDC's, I think we would have a very serious situation. We are seeing that a good many industrial countries, like Germany, are running important deficits. And, of course, countries like Germany are perfectly able to finance that kind of a deficit. They are good credits, the best. The Europeans and Japanese, and the United States, can afford to go through this adjustment period.

I don't mean that at one point we won't all have to adjust, at which point there will be a new economic situation in the cycle anyway. But there is, I think, the danger of everybody in the industrial world acting at the same time in the same direction; then that would hit the LDC's very badly.

Finally, Mr. Chairman, you asked how does our bank assess riskiness of loans to less-developed countries and are there indications of an increase in this riskiness.

It is a piercing question. It is not a thing that is particularly subject to precise definition. There is a great deal of judgment in it.

For example, our economists' department at Morgan Guaranty is independent of the international division. It is organizationally in a different line of responsibility. I think many of you know Rimmer de Vries, our international economist. I guess one would not need much structure to keep Rimmer independent, but he is independent, fully independent. He and his associate economists work very closely with our general bankers.

Our general bankers are organized on an area basis. They have had a good financial background. They travel a good deal in the countries for which they are responsible. They have good access to information. But they can be wrong.

My job is basically to see that the structure is there and that the bankers are right most of the time.

We establish overall country limits, and these cannot be changed except with my consent and that of the international credit officer of the division. But we work very closely and continuously with all of the different areas, trying to give them the responsibility and

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decisionmaking capability to handle their business, and the accountability if they are wrong.

As I say, it is difficult to attach very precise mathematical formulas.

Now, having said that, I don't want to imply that one should not have a number of tests and constant questionings of the changes in the economic situation, the political outlook and the management of the countries, on their general response and their basic stability.

I think, if we are able to continue to do this in an intelligent and thorough fashion, my opinion is that we should be able to increase our lending to the LDC's.

The relationship of the banks to the IMF is one which, of course, is a matter that we have given a great deal of thought to over the years, amongst ourselves and in conversation with the IMF and the World Bank. I think the IMF and the World Bank are working together more in the sense of programs that fit together. The World Bank seems to be involved now in a number of program lendings, which certainly supplement the IMF.

The banks relationship the IMF: I am a little hesitant to go to a form of institutionalized exchange of information, as Mr. Heller mentioned. What troubles me about that kind of a method is that I think the world system benefits from the fact that different institutions are making different decisions under different responsibilities.

The banks do not act monolithically very often. They seem to be moving much in the same direction at the same time. Of course, there is a certain element of herd instinct in this kind of a thing. But I think it is important that banks make up their own minds and make them up individually, keeping very much aware that they should not be making decisions that interfere with or hurt the decisions of the public lenders.

Thank you.

Chairman NEAL. Thank you, Mr. Vagliano.

Mr. Balatsos, welcome to you this morning.

STATEMENT OF DIMITRI BALATSOS, VICE PRESIDENT, INTERNATIONAL ECONOMICS, MANUFACTURERS HANOVER

Mr. BALATSOS. Thank you, Mr. Chairman.

I have submitted written testimony. I would like, for the next few minutes, just to read from the text.

I appreciate the opportunity to testify before the subcommittee on the important issue of U.S. bank lending to oil-importing countries, particularly the less-developed ones.

Deepening payments and balances in the wake of last year's steep climb in OPEC oil prices now threaten the world economy, with a setback of potentially greater magnitude than even the 1974–75 episode.

One way to hold this threat at bay is to safeguard the smooth functioning of the international financial system. Since commercial banks constitute the fulcrum of the system, their ability to remain active participants in the international intermediation process must not be unduly impaired.

The subcommittee has invited comment on what factors might constrain U.S. bank lending to LDC's in the next few years. The record shows that the share of total international lending provided by U.S. banks has fallen steadily, from 28 percent in 1977 to an estimated 24 percent in 1979.

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Unless used with caution, however, the figures can be misinterpreted as a retrenchment by U.S. institutions. The fact of the matter is that in absolute terms the volume of international loans by U.S. banks has expanded handsomely during this period of time.

Also, commercial banks abroad, partly because of the depreciation of the dollar, have seen their assets grow steadily, in many instances outdistancing their U.S. counterparts.

So, it became arithmetically inevitable that their share of international lending would surpass that of U.S. institutions.

In addition, it is important to note that in spite of their decline overall, U.S. banks, as a group, continue to dominant lending in many selected markets around the world.

Two additional factors that help account for the United States lower percentage of loans in recent years have been the deterioration in lending margins to levels considered inadequate to compensate the lenders for the costs and the servicing of new credits, and the high degree of concentration of LDC loans already in the portfolios of American banks.

At the same time, foreign banks enjoy relatively low levels of risk concentration and generally lower assets to capital ratios, allowing them to expand their global market share a pace.

Where the share of lending represented by U.S. banks will continue to decline in the coming years hinges on several factors. Domestic economic conditions—that is, domestic in the U.S.—is one of them. My best guess is that the American economy will go through a moderate recession between mid-1980 and early 1981, followed by anemic growth in the following 2 to 3 years.

This period will also be characterized by sluggish growth in domestic loan demand, so that for any given level of capital, U.S. banks, as a group, will be able to expand their international lending activity.

Similarly, economic conditions in other major industrial countries are also expected to weaken markedly in the second half of 1980, with an average rate of real growth for this group of countries of around 1 percent in both this year and in 1981.

Consequently, lessened demand for funds in the industrial nations is likely to release resources for lending elsewhere.

The level of U.S. banking exposure and bankers' appreciation of country risk will also determine how much new credit will be extended to the LDC's.

However, for neither criterion is there a tangible yardstick available that can give a clearcut answer. But watchful attention of the regulatory authorities, not withstanding prudent asset management, requires portfolio diversification.

Generally speaking, U.S. bank loans are likely to be less readily forthcoming for countries where exposure is already high.

However, this general statement might not be equally applicable for individual banks, for country exposure varies widely even among a handful of the largest institutions. Nor is it possible to determine country risk appraisals on the basis of simple numerical formulas. The exercise usually consists of the weighing of a complex set of economic and sociopolitical forces, as well as taking into account such things as the length of the credit relationship and so on.

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Today the emerging economic fragility worldwide has also coincided with rising political tensions in the Middle East, Central America, and elsewhere. The resulting reappraisal of risk has already started to be reflected on average in a firming of lending margins and a decrease in the tenor of internationally syndicated loans.

The likely outcome of this process might be the establishment of a multitier system that will continue to afford favorable lending terms to top quality borrowers, but less creditworthy countries will have to pay higher spreads over LIBOR to obtain funds.

Those at the bottom of the pyramid will probably have to resort to the IMF borrowing and to other official sources.

In addition to alleviating country risk, wider lending margins will also improve banks' earnings. So, with any given capital assets' ratio, more lending can take place overall.

The continued participation of foreign banks in international lending, as mentioned earlier, will be another factor that will influence the U.S. bank share. The larger assets size and smaller exposure to LDC's by this group of lenders suggests substantial ability on their part to continue to expand their loan share.

While such growth had been slowed recently by foreign regulatory authorities, tightening their supervision, weaking economic growth abroad, and widening lending margins induced by a more a fragile world economy should position banks to step up credit availability to developing countries.

Furthermore, the way in which the LDC's themselves are likely to respond to the mounting needs for external financing will also be a key to the recycing of petrodollar flows. The larger borrowers have imposed restrictive monetary and fiscal policies to reign in inflation and reduce budgetary deficits.

These moves imply a widespread recognition that there is no painless way out of the present situation. Parenthetically, it should be noted that a substantial portion of the projected wider LDC current account deficit is not oil related. Rather, it reflects heavier debt service requirements stemming from historically high interest rates that prevail today and have been prevailing for some time.

To the extent that economic conditions weaken worldwide this year or next, interest rates will come down and alleviate the debt service burden of developing countries. Moreover, other economic factors will also soften the impact of the latest OPEC price hike on LDC's.

Export growth is likely to hold up relatively well this time around. On a best guess basis, economic activity among industrial countries will slowdown markedly in 1980 and 1981, but on average will stop short of a recession.

Commodity prices, though expected to soften further, will probably not collapse as they did in the 1974–75 recession. Also trade among the developing nations has increased significantly, making them less dependent on industrialized markets.

In addition, substantial remittances flow back to the LDC's from their nationals working in OPEC countries. Moreover, unlike 1974–75, with LDC exports projected to hold up reasonably well, the ratio of their combined current account deficits to exports is likely

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to deteriorate only marginally in 1980–81. This might be especially true for the top dozen or so borrowers.

Some drawing down of international reserves, finally, which have been replenished in recent years, will be yet another way for the LDC's to tide themselves over.

The subcommittee has also invited comment on whether banks are reaching their lending limits to the largest LDC borrowers. It bears repeating that House limits should not be viewed as rigid yardsticks or cast in bronze. They are rather flexible concepts that take into account a host of factors, ranging from rates of return to the projected amortization of existing exposure and risk concentration.

As mentioned earlier, prudent asset management requires diversification. All in all, it is realistic to state that banks, particularly large money-center institutions, are approaching prudent limits in financing certain developing countries. Nevertheless, it does not follow that these institutions will not remain active creditors to these countries. Instead, it implies that it might be necessary that other sources of funds step up their share.

The impact of U.S. monetary policy on bank reserve growth and the implications for lending to the LDC's were other concerns of the subcommittee. There is no sure way of distributing the effect of Federal Reserve actions on credit availability to different borrowers.

Consumer-type borrowing in the United States has already retrenched appreciably, but corporate financing needs will probably continue strong for the foreseeable future. However, as the economy weakens further and inflation abates somewhat, domestic demand for funds overall will also decline.

As a result, U.S. banks might be in a better position to expand lending abroad. Ultimately, however, the amount of loans directed to any given borrower will be determined by the host of criteria that go into prudent asset management.

Moreover, as important as the U.S. credit market is for international lending, it does take second place to the Eurocurrency markets, which not only provide the bulk of the financing to the LDC's, but also tend to be relatively insensitive to Federal Reserve actions.

Meanwhile, a more significant side effect for the LDC's of the recent tightening of Federal Reserve policy will come from lower U.S. interest rates later on this year. Since United States and Eurodollar interest rates move in tandem, the debt service load for LDC's will lighten as interest rates abroad follow the U.S. rates down.

The subcommittee also wanted to know whether a larger amount of the OPEC surplus can be recycled to oil-importing LDC's through channels other than commercial banks. Generally speaking, I do not expect that over the foreseeable future, private nonbank sources of funds will open up in any significant way to the LDC borrowers.

Both the United States and European capital markets are currently in disarray because of historically high inflation and interest rates and are very quality minded. But until there are convinc-

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ing signs of a decided deceleration in inflation worldwide, these markets are not likely to open up except to top quality credit.

By comparison, official lending channels and/or expanded bilateral lending between OPEC members and LDC borrowers appear to be a more viable alternative.

The subcommittee has also expressed interest in possible indications of increased riskiness of loans to LDC's. As mentioned above, there are no rigid indicators for measuring country risk. Risk assessment is applied individually on the basis of a complex procedure that takes into account subjective as well as objective considerations.

In a general way, economic indicators are now showing some deterioration. The balance of payments position of non-oil LDC's has worsened as reflected in the $50 billion deficit at year-end 1979 compared with a $7 billion deficit at the end of 1973, just before the 1974 recession.

The level of external debt of developing countries is also considerably higher, and debt service requirements are larger. Counterbalancing these weaknesses, however, are the several positive developments that were mentioned above. On balance, the financial position of LDC's as a group appears to be only marginally impaired.

Regarding closer cooperation between the IMF and commercial banks, I feel that it will be a step in the right direction. The IMF possesses an appropriate framework for guiding member countries through financially difficult straits, an asset that the commercial banks lack at the present time.

In conclusion, I find that it has been the close cooperation of central banks that has largely kept the international system together and relatively free of disturbances in the face of growing economic uncertainty and volatility worldwide. That cooperation must certainly be encouraged to insure that the world economy withstands the strains of intense inflation now upon it and returns to stable growth rates and rising living standards before long.

Thank you, Mr. Chairman.

Chairman NEAL. Thank you, Mr. Balatsos. I would like to thank you all for coming and helping us in our deliberations on this legislation.

I think if the members of the subcommittee agree that on the first round we could limit ourselves to the 5-minute rule and everyone would have a chance to ask a question, then we can go back on a more informal basis and take what time is necessary.

Let me just say, I think it has become abundantly clear during the course of these hearings that no one seems to have a very good method or very good advice on how to get the OPEC countries more directly involved in lending or investing their surpluses in some of the lesser developed countries.

I would like to especially commend Mr. Cavanaugh for his efforts in bringing this clearly to our attention. I have written to our Secretary of the Treasury and the Federal Reserve, urging them to try to take the lead in getting the industrialized countries around the table with the OPEC countries to try to convince them that this is in their best interests.

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Do you all have any other thoughts on this subject? Maybe you have some other ideas. It seems to me that this is clearly at the heart of the problem, yet we don't seem to have a very good mechanism for dealing with it.

Any thoughts? Yes, sir?

Mr. BALATSOS. May I remind you, Mr. Chairman, in the last OPEC meeting last December, there was a proposal by a couple of the members that they establish a special fund, directing its attention to the more hardpressed LDC's. Whether or not they will, in fact, forge ahead and develop such a facility, of course, is in a speculative state at the moment.

We have seen, nevertheless, more recently, since roughly the beginning of this year, an increased interest on the part of some OPEC members. In this particular instance, the episode comes to mind that some of the Saudi Arabian monetary authority—they have been providing direct credit to major corporations, referring to the IBM borrowing of about $350 million from SAMA—also some other OPEC members having shown some interest in actively participating in major industrial countries.

They have established some equity participation in Japan in one of the major electric companies. So the bottom line of all this, in my opinion, is that truly, the OPEC nations as a group will begin to diversify their portfolios, but their diversification will probably be directed in favor of the top-quality, private borrowers in the industrial nations.

Chairman NEAL. Anything else?

Mr. HELLER. First of all, I think it is important to remember that there are quite a few new-founded Arab banks and existing Arab banks that have become more active internationally, that partake in the recycling process. They still play a minor role, but they play an increasingly important role, which means a direct stake for the OPEC countries in the recycling process.

Then, as I pointed out in my testimony, there should be more international bond issues that will directly be taken by the OPEC countries, more direct equity participation, and consideration of the formation of an international investment bank where they would hold the direct equity. This may be not unlike PICA, the Private International Investment Corp. for Asia. It operates on a very small scale but successfully in channeling funds directly into productive investments and giving a profit return.

Mr. VAGLIANO. Mr. Chairman, I might just add that the process is not a kind of instant learning thing. There are some real institutional skills that have to be developed—people skills, judgment skills, decisionmaking skills—while confronted with the enormous problems that the OPEC countries have of developing their own countries of trying to figure out what projects make sense for them—all of this in the context of a shortage of people.

Under the circumstances and the kinds of skills needed, I think it is inevitable that it has been a slow process. But there are signs of greater willingness to put human resources to work and eventually financial resources. The bankers around the world have been active in showing private placements to OPEC investors as Mr. Heller mentioned. I think that this will continue to broaden and that it is a process that will grow.

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The difficulty is, I think, that from a timing point of view, you have a need to get over this particular period. Here, we are talking about a flow of resources that are very large. So I don't think one can expect terribly rapid change in the attitudes of these countries, but I think there is some change. Certainly one of the reasons I think that this particular decision on the IMF is an important one is that it is another indication of countries and governments working together.

Chairman NEAL. I would like to ask each of you in turn, how do your loan loss ratios for your international loans compare with your domestic loan loss ratios? If you would like to comment on the industry as a whole, that would be helpful too.

Mr. VAGLIANO. I can speak to our own situation, which is reported in our 10K category of nonperforming loans to LDC's. At the end of 1979, it was $26.6 million. It varied from 11.3 in 1976, 17.1 in 1977, 15.4 in 1978, which of course is a very small amount compared to our loan portfolio. But I think it is correct to say that these figures show very small losses in international lending to LDC's, which has been historically correct since World War II. The number of defaults and reschedulings has been small, but I don't think one should take excessive comfort from that fact because we are coming into a situation where there are strains and where there could be problems.

In that connection, I think one should look at what is sovereign unwillingness or inability to pay, because what we are really talking about in most instances that one can conceive of is, at worst, a rescheduling of debt, a restructuring of debt, which actually in a market sense takes place all the time anyway. These people take advantage, as the LDC's did last year, of favorable conditions and borrow heavily, and as a result, increase their reserves.

But in terms of actual loss or default, you really have to assume the willingness of a country to remove itself from world trade and the world economy, as was the case in Cambodia. It cannot operate any kind of significant trade and significant investment—any kind of significant activity—if it is defaulting on its debts.

So the problem, which is the one, Mr. Chairman, you have been referring to is really that as to how the burdens on these countries are handled and how the adjustments that are required by the circumstance of a change in energy costs are handleable, but I do not think that looking at these figures, whether they are large or small, is necessarily helpful.

Chairman NEAL. What am looking for is some judgment, some crude analysis of what has been the case, and then your judgment as to the future. I guess what am really asking is, do you foresee that this could become a big difficulty for the American banking system in the future? Whatever it so far is, you don't see that as being a huge problem?

Mr. VAGLIANO. No, I do not, sir.

Chairman NEAL. Do you all agree with that in general terms?

Mr. HELLER. Certainly, in general terms I would agree, Mr. Chairman. The loan losses, as I pointed out in my statement—foreign loan losses in 1979—amounted to something like 0.31 percent of the total loans outstanding. That means on $100 worth of

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loans, we lost 31 cents. In 1978, it was only 13 cents for $100 worth of loans.

That is broadly comparable to the domestic experience and has been so during years past. Obviously, there is a wide variance in that loan loss experience, depending on the type of loans that you have. For instance, loans to individuals are much more risky than loans, made as mortgages—real estate loans—and also commercial and industrial loans. I think it would be wrong to see all lending to LDC's as being subject to sort of the same kind of danger, the same kind of riskiness.

Approximately 40 percent of Bank of America's foreign lending is actually lending in the currency of the country where the loans are being made. So in that sense, it is very much the same as domestic lending in the United States, and it is not subject to transfer exposure—the ability to service debt denominated in a foreign currency.

Some of that represents consumer lending; some of it industrial lending. So again, a broad generalization, I think, is difficult to make. But if you want to make one, yes, the international experience has been broadly comparable to the domestic experience.

Mr. BALATSOS. I would like in general terms to support my brother witnesses. The record has been good, but I think economic events worldwide will probably play a role in determining that the 4 months of international loan lead is common. If we go through a very severe recession worldwide, I would not be surprised to see more cracks and risks developing. But barring that, if we go on the basis of history, then I do not anticipate any dramatic change in the picture in the years to come, the next few years anyway.

Chairman NEAL. Thank you very much.

Mr. Cavanaugh, would you Chair the hearing for a few moments?

Mr. CAVANAUGH [presiding]. I recognize the distinguished——

Mr. STANTON. No, go ahead.

Mr. CAVANAUGH. You all seem fairly confident that the existing structure is working and will continue to work.

Mr. Heller, you do state that the structural changes that need to be undertaken in response to this price increase are vast, referring to the most recent OPEC price increases, but you seem to be alone in recommending the necessity of any significant structural changes to the international monetary system.

And Mr. Vagliano, I take it from your comments that you are at variance with the assessment of your house economist, Mr. de Vries. In the New York Times on April 14 1980, he is quoted as saying: "The financing of the new imbalances and the refinancing of existing obligations as they mature imply considerable risk to the world's financial system."

As I understood your testimony here today in response to this subcommittee's fifth question, are there any indications of increased riskiness of loans to LDC's, you left me with the conclusion that there wasn't any significant increase in the riskiness of the loans to LDC's and that Morgan was going to continue pretty much as it has. Is that an accurate understanding, and are you at variance with your economist's interpretation of riskiness?

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Mr. VAGLIANO. No, I am not at variance, sir. I think maybe we are talking about a difference of perhaps emphasis here. I think in my statement I did mention that we were in perilous times, risky and dangerous times. Obviously that very basic condition in which the world finds itself adds to the overall risk.

What I was saying, on specific loans to LDC's, I think that our procedures, our judgments, and our ability to determine which are sound loans is still valid, and I have confidence in it. And I have confidence in it to the point of being willing, in the right circumstances, not only to continue but in some instances to increase our LDC lending.

I did not mean to imply that I did think that the world as a whole is at greater risk. We have got to get over this adjustment period, which is going to be tough.

Mr. CAVANAUGH. Well, you understand, I would hope, the purpose of the hearings and the reason that Congress is interested in hearing from you is to determine whether or not there need to be changes in public policy that would facilitate changes in the economic conditions that exist in the world.

My understanding of your testimony would be that there are no changes in the economic conditions in the world that necessitate any significant changes in international economic public policy to be initiated by the United States—that as you view conditions in answer to the question, are there indications of an increase in the riskiness of loans to LDC's, your answer would be no, there are no indications of increased riskiness that would necessitate any significant changes on the part of either U.S. policy or international policy that should be promoted by the United States. Is that correct?

Mr. VAGLIANO. Except, Mr. Cavanaugh, this particular legislation which we support, which I think would be a positive effort, giving greater resources to the international institutions which can play such a vital role in getting through this adjustment process. And I think that is very important.

Mr. CAVANAUGH. But you see nothing beyond this legislation that is necessary? Basically the system is working?

Mr. VAGLIANO. I would hesitate to testify that we are in a perfect world, but I think that given the way private and public institutions have responded since the first problem in 1974, the reaction to the increase in energy prices has shown that the various institutions that we have, while by no means perfect in every sense, have handled change with success and with cool.

One is always afraid in a structure that depends so much on confidence, that a series of unfortunate events together could shake that confidence, but I think the institutions have shown strength.

Mr. CAVANAUGH. Well, then, if you could explain to me your interpretation of Mr. de Vries' statement. What is he speaking about when he says it implies considerable risk to the world's financial system? What kind of risk is he talking about?

Mr. VAGLIANO. I think one of the things that he is talking about, because we have talked about this at some length, is the matter I referred to about the critical situation that would arise if all of the developed countries took similar corrective action for their balance of payments at the same time, particularly protectionist action.

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That would really make it very difficult for the LDC's to be able to adjust.

And I think one of the things—and think I can speak for Mr. de Vries on this, on his analysis of the adjustment that took place in 1974—one of the things that made it particularly difficult for the LDC's at that time was the fact that we had a fairly even recession throughout the industrialized world, and the effect on LCD exports perhaps had a greater shock than the energy costs.

Mr. CAVANAUGH. Mr. de Vries is not addressing the recycling process or the surplus/debt process. He is concerned primarily with trade balances and protectionism.

Mr. VAGLIANO. That additional shock to the LDC's, yes, sir.

Mr. CAVANAUGH. Thank you, Mr. Chairman.

Chairman NEAL [presiding]. Mr. Leach?

Mr. LEACH. I would first like to make some comments.

Sometimes in Congress we tend to be overly critical, but I would say the private banks have really done more in the last decade than any other institutions to correct some difficulties that have arisen politically and economically in the international marketplace.

By the same token, Rimmer de Vries points out that the institutions which responded so well in the 1970's might not be in the best position to respond as well in the 1980's. All of you have, as I read your statements, a double-edged statement. That is things could go very well, or they could go very poorly. The banks are sound, but it is imperative that the IMF take them off the hook. In other words, we are entering perilous times.

If these perilous times are to be avoided, the institutions must adapt. In other words, this brings us directly to the specific of how you respond.

I particularly appreciate, Mr. Heller, your statement, mentioning new institutional arrangements—for example, the international bond market aspect.

The difficulty that strikes me with a bond market approach is that the OPEC countries will obviously choose to purchase IBM bonds instead of LDC debt offerings, and as they go for IBM and in effect outcompete you for this business, international banks will have to go for second or third quality lending. But you have all strongly indicated that the banks are unwilling to go with lower quality lending. Therefore it would appear that as there is more direct lending from OPEC to first-rate quality institutions, the banks will settle for second-rate risks, and the IMF will be left with third-rate risk taking. That is going to create a very difficult situation for the IMF, both in terms of the Fund being tougher in many regards than the banks in terms of its requirements as well as the social implications for those countries.

I particularly appreciated your characterization, Mr. Vagliano, when you said part of the baggage of being rich is that OPEC should have to start taking greater risks. The question then comes: are there institutional ways to force OPEC countries more into riskier lending?

In that regard, one of the ideas that has been preferred is what you mentioned about using the IMF as an institutional vehicle to guarantee loans, thus leveraging and at the same time perhaps

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directly involving countries that might not want to take those risks. I think that idea has some real merit.

I am not sure just what role the commercial banks would play. One of the notions talked about in recent months is that commercial banks might, to a greater extent, package loans.

Do any of you visualize commercial banks playing a role in packaging loans for OPEC countries, that would then become guaranteed by the IMF? Does that strike you as practical or are there problems with that type of approach?

Mr. VAGLIANO. I think it is an appealing thought. The difficulty, of course, is how it really works in practice, because in the final analysis, somebody has to make the decision on that risk, and somebody must make the decision of making that loan, taking that risk or not.

The problem with this is as follows. The banks presumably put together a package of loans. The IMF would, in a sense, give some formal blessing to it. If it goes as far as a guarantee, you are not really adding to the risk-taking of the OPEC countries. If it is less than a guarantee, you come back to the initial problem of this institutional question, developing the willingness and the ability to make these judgments.

So I don't mean to be excessively negative on this, but I think the fundamental willingness to put some of the excess assets at greater risk is going to be a slow process, and it is going to be difficult to push them into.

I think there are a lot of practical things one can do in terms of training and in terms of giving courses on risk evaluation. As for our own institution—and I am sure others are doing the same thing—we have seminars of several weeks for central bankers with whom we spend a great deal of time and money. And I think it is well worth spending on this kind of thing, but it is not going to solve the immediate problem.

Maybe something of that kind might be the answer, but we are still going to have the problem of the final decision. Who makes the decision, and what happens if it is wrong? Do they go back and ask the IMF——

Mr. LEACH. Let me make one other point. Speaking of perilous political times, we are also in perilous interest rate times. As Mr. Balatsos indicated, international rates seem to go up or down almost in tandem with U.S. domestic interest rates. We seem to be focussing on only one statistic—that is, the enlarged OPEC resource development because of higher oil prices—but looking at OPEC as lenders there is also greater OPEC resource development because of higher interest rates. It places a double burden on the developing countries, not only in terms of the dollars they spend, but also the interest rates they pay which are a quantum magnitude above those prevailing in the 1970's.

If interest rates maintain this high level, is that, in and of itself, going to cause an economic instability similar in dimensions to enormous political instability? Would any of you argue that 21-percent interest rates are such a different world than 12-percent interest rates that they could jeopardize the economic order of the world?

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Mr. VAGLIANO. Mr. Leach, I think you are right. I think it is a very dangerous thing, and I think that if interest rates were to continue upward at this level for a long period of time, the LDC's and others would be forced to adjust in a severe fashion, with all that that entails in terms of social and political difficulties. These very high levels of interest rates—and of course part of the purpose of them is to reduce borrowing internally in our own country—are bound, if they keep on for a long time, to have that kind of serious impact.

People generally are beginning to recognize now that things have peaked and interest rates are on their way down. If they go down rapidly, this will have been a bubble in a sense, which will have served a particular purpose.

Mr. HELLER. I do not differ greatly with your analysis, but I think again there is a big danger to lose perspective. If you look at the total interest cost of all the loans made to developing countries outstanding right now, you will find that the average interest rate paid by all developing countries together is approximately 7 percent.

If you look at the World Bank financing, for instance, it is still done at very low interest rates, largely because the World Bank concentrates its own borrowings right now on countries like Germany, Japan, and Switzerland, where much lower interest rates than in the United States are still prevailing. That is then reflected in the loans made to developing countries.

Finally, if you look at the portion of LDC debt that is truly interest-sensitive in the sense of these floating rate bonds that we have been talking about before—and as you well know, the data in the Eurocurrency are not all as clear as we might hope for—but if you look at the net borrowing by countries—and the latest data available here are 1978 data—you find that the non-oil developing countries have borrowed some $40.1 billion in the Euromarkets. They have placed some $39.8 billion in the Euromarkets, largely in the form of these international reserves that they are holding, and their interest earnings are also rising as their interest costs go up. I am talking about net numbers here.

If you look at gross numbers, there is a larger discrepancy there. If you look at gross numbers, it is about $123 billion in liabilities by the developing countries versus some $78 billion in assets. So there is more of a difference. But if you look at the net taking of funds, in particular that interest-sensitive portion, the picture is not all that alarming.

Mr. VAGLIANO. I would agree with Mr. Heller. The first of my remarks were aimed at this continuing for a long period of time during which the reserves would come down and the interest earnings would fall off.

Mr. LEACH. I have some more questions to pose during the second round.

Chairman NEAL. Mr. Stanton?

Mr. STANTON. Thank you, Mr. Chairman.

Gentlemen, I join the subcommittee in thanking you for your testimony.

Both in the verbal and the written testimony, it struck me—a very similarity of opinion in regard to the legislation here before

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us, obviously encouraging the subcommittee to act favorably on it. Whatever differences you have might either be minor or of less degree, but I would be interested in the three of you recognizing this may be a difference only in degree or maybe there is not any difference.

What opinion or disagreement one of you might have with the other one in what you had said here this morning—is there any difference that any of you honestly publically would express? Do any of you feel inclined to do so?

Mr. BALATSOS. You are looking for some entertainment, is that the idea?

[Laughter.]

Mr. STANTON. As Mr. Cavanaugh said, you have come a long way. Does anybody want to take me up on that?

Mr. LEACH. If the chairman would yield, the Greeks, the Italians, and the Germans have always gotten along very well.

[Laughter.]

Mr. BALATSOS. Very well said, Mr. Leach.

If I may take a second, it is a matter of degree here. It is not a matter of underlying substance. The general impression that I get from my colleagues on the panel is that things could go wrong. The question is, will they, in fact, go wrong, and what degree of probability can we ascribe to that going wrong?

I don't think there is any of us that in all honesty can put a number to that probability. The system has been resilient more so than many analysts concluded—many major bank analysts back in 1974 and 1975.

I have a great deal of difficulty when it comes to this whole question of debt. I have always subscribed to the view that debt is like morality—it changes over time. I don't believe that our grandparents morals apply equally well today as they did back then. I think we should face the realities of the world today. We have leverage in the world economy. By increasing the amount of debt, is that inherently wrong and immoral?

The answer is no. I see nothing to support that contention. But I think we should build some safety margins. This is really what we are here for today, if I can speak for myself anyway, to provide just that safety margin by recommending that IMF plays a more active role in international financial arrangements.

I would be the last person in the world who would like to test the resilience of the system.

Mr. HELLER. I agree with that statement.

[Laughter.]

Mr. STANTON. I suppose you all agree with the premise, I think it was on page 6, Mr. Heller, in your remarks, you spoke about curtailment of expansion of the foreign banks in the international field. Particularly, I think, you referred to the Japanese's rapid increase in expansion, and you spoke that the reason the Japanese banks were now retrenching was at the request of their Minister of Finance. Does the U.S. Government play a similar role with our banks?

Mr. HELLER. Well, certainly the Japanese example is not an example of the much heralded Japanese cooperation where the government and the industrial sector work hand-in-glove so to

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speak. Instead here you have an example where the government really pulls in the leash rather sharply on an important part of the Japanese industrial/financial establishment.

Mr. STANTON. Obviously, what we all know is that the Japanese government has a greater degree of control over the activities of their banks, their lending institutions, than the United States has.

Mr. HELLER. Oh, no greater. The Federal Reserve has considerable control and has exercised that control very recently, setting precise targets on the domestic side. I am not a lawyer, but I assume they have also a capacity to do similar things in the international arena.

You see, the Japanese situation was really one which, as has come out in the testimony, the Japanese banks went in very aggressively over a period of time, expanding their international loan portfolios at rates between 20 and 30 percent per year. And it was that very high rate of expansion that caused the alarm of the Japanese authorities. Therefore, the cutback in activity abroad was recommended by the Minister of Finance. So, it was, I think, a reaction that was very much in response to a development which had been viewed as being excessive on behalf of the Japanese authorities.

Mr. STANTON. This is particularly true in South America.

Mr. HELLER. South America was one area where the Japanese had become very active.

Mr. BALATSOS. I think it also reflects the current economic situation in Japan, especially the deep current account deficit that started under way in the second half of last year. This is another factor that, in my opinion, started to limit, or led the minister of finance to restrain, Japanese bank lending abroad.

Mr. VAGLIANO. First, if I may correct the record. I am afraid this group is ethnically loaded. My name is of Greek origin also.

Mr. LEACH. Pardon me. An apology is due.

Mr. VAGLIANO. I think there is one factor which is, perhaps, inevitable, as in the Japanese situation, when their banks came very actively into the market and then pulled back. I think this is an element inherent in any market. At certain times you have more or fewer participants. I think the market is now big enough so that certain banks are pulling out and others are going in. It is perfectly handleable. Nevertheless, of course, continuity in the relationships is something that is important. A sudden pullout by one group of lenders can cause some disruption.

Chairman NEAL. Mr. Heller, you mentioned a couple of ideas that attracted my attention. I just wonder if you would expand a little bit on both of them. You suggested revitalizing the international bond market. I would like to know more precisely what you have in mind there. You also mentioned the formation of an international investment bank. I wonder if you would expand on that idea.

Mr. HELLER. Yes. As you know, the international bond market has greatly decreased in activity at the same time as the domestic bond markets have also come to a virtual standstill. I think the area of long-term fixed-interest-rate bond ıes is, I don't want to say past, but certainly these type of bond ıes will become much less important in international lendin[illegible] refore, something like

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floating-interest-rate bond may well be an appropriate vehicle to shift some of the risk of interest fluctuation to the borrower's side, while the ultimate lender holds the risk of ultimate default, the creditworthiness risk, therefore bypassing the commercial banking system and not impinging on the capital ratios of the commercial banks. In that sense, I would talk about it as a revitalization of the international bond market by using instruments that are more amenable to periods of time where we experience high and variable rates of inflation.

To turn to the international investment banks——

Chairman NEAL. Excuse me, before you do that. Who are you suggesting take the lead in this idea?

Mr. HELLER. I think the market will do that. The market will in itself——

Chairman NEAL. You think this is going to happen automatically, and you are just supporting it, that is all?

Mr. HELLER. Yes.

Chairman NEAL. I see. Excuse me. Please go ahead.

Mr. HELLER. The idea of an international investment bank would really give the investing countries—and I would look at the OPEC countries as well as perhaps some of the industrialized countries—it would give them a direct stake in the performance of individual economies to a much greater extent than they have now. As you know, most of our officially channeled funds really take the form of fixed-interest-rate loans to developing countries. There is no tie-in here to the actual performance of the individual countries. There is no assurance—in some cases, at least, there is no assurance that these funds are spent for productive purposes.

World Bank loans, for instance, are a notable exception here, where you have direct project supervision and there is an assurance that the funds that the World Bank lends are actually used for these productive purposes, that they will thereby strengthen the economic fabric and the export-earning capacity of the developing countries.

An international investment bank would provide some equity participation and would help in the development process. And I would guess—I am not certain; obviously, the reaction has to be seen—I would guess that there would be less objection in the developing countries because they would then be faced with just an international institution, rather than having to face one specific direct foreign investor, with the tensions of host country versus investing countries attendant thereto.

The investing countries who would buy shares in that particular international investment bank, they would have the advantage of portfolio diversification. They would have not a direct stake in any one project, but they would be holding a diversified portfolio of foreign-investment projects.

So there would be certain attractions as far as risk diversification is concerned, and as far as expert management is concerned. This maybe especially important for smaller OPEC countries—some of the Gulf States, for example—that really do not have the know-how and the management expertise. Although, as was pointed out before, their expertise has been increasing, it would be very

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difficult for them to supervise and see to fruition direct-investment projects that could be accomplished through such an institution.

Chairman NEAL. Are you suggesting that this would be a new private organization or perhaps something established under the auspices of the World Bank?

Mr. HELLER. Without going into details, let us say, in cooperation with the World Bank would probably be a very useful way to approach it, rather than setting up a whole new separate international bureaucracy; utilize the expertise of the World Bank; both as far as countries and as far as projects are concerned, and not have another separate organization.

It would be different, maybe, from the International Finance Corporation in the sense that we would have regular shareholders; people would be paying in. Whether you want to draw a distinction between public and private—I am certainly not for that distinction between public and private, but sometimes it is necessary to draw it in order to get the cooperation of foreign governments to participate and who might insist on it.

As I pointed out before, there is such an institution already in existence for the private sector, but it is very, very small indeed. It is something like $100 million or $150 million.

Chairman NEAL. I am not familiar with that institution. What is that?

Mr. HELLER. It is called PICA.

Chairman NEAL. For Asia?

Mr. HELLER. For Asia only. And it is a successful institution.

Chairman NEAL. Thank you very much.

Mr. Cavanaugh.

Mr. CAVANAUGH. Thank you, Mr. Chairman.

I want to thank the chairman for continuing these hearings and inviting you for participation today, and for your attendance. We did have some difficulty in soliciting a positive response from the commercial banks. And so I am grateful to those who did respond. And you have contributed, I think, significantly to the basis for this legislation and assisted the Congress in fulfilling its obligations in scrutinizing the totality of the issues which this legislation entails.

Mr. STANTON. Would the gentleman yield? I would just simply point out for the record that the lending institutions' cooperation with the subcommittee was much better than it was with Chrysler Corp.

Mr. CAVANAUGH. I am not sure if that means that we are going to last longer.

Mr. STANTON. Excuse me.

Mr. CAVANAUGH. But I would like the record to reflect that not all financial institutions cared to respond to the Congress. In fact, the Chase Manhattan Bank refused to respond to the subcommittee, and that, I think, is seriously unfortunate because the issues which we are addressing here are significant to the country and to the future of world order, and you and your institutions play a significant role in that. If we can't work together in dialog in public policy, there is no way that we can confront the challenges that are presented to us by the disruptions that we now face and must manage in the world of order.

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So, you are to be commended, I think, for coming. Those who refused, I think, should appropriately be pointed out, their unwillingness to contribute constructively to this process.

With that, I must still say that I am somewhat disappointed in the testimony. I think, Mr. Heller, that you have made some constructive suggestions and applied some imagination to the challenges that we do face.

But for the most part, I think the panel's presentation has reminded me of an occurrence that I had when I first came to the Congress. I had the home of the Strategic Air Command in my district, the SAC air base. There was difficulty there at the hospital, where they had 28 physicians who wrote in protest to me that they were not able to meet adequately the medical needs of their service population, which was about 55,000 people. They had inadequately trained personnel to meet the unlimited demands of this whole population.

I initiated an investigation, in which the command of the Air Force reacted with great hostility, maintaining that there was adequate personnel and adequate resources, "28 physicians was a sufficient number to meet these unlimited demands."

Finally, we had a meeting after this had gone on for several months, and they came to me and said, "Well, Congressman, we do know that you are right and that there are deficiencies and inadequacies in the military medical system. But, you know, it would destroy our credibility if we admitted them."

That is somewhat the circumstance that we have, I think, in the world economic problem: that there are admitted serious deficiencies, but it would apparently impair everybody's credibility to admit them, and therefore we are paralyzed in our ability to address them.

The reason you were invited here, I think, is to provide us some input as to whether or not there are things that we should do beyond this $5.4 million quota increase to the IMF, there are other things that are necessary for the United States to do to initiate the initiatives in order to improve the international monetary structure.

And with the exception of Mr. Heller's suggestion, the message to us is that there is nothing. I think we can probably rest on that. We will comply with it. We won't do anything and the administration won't do anything, and there won't be very much public discussion in the country about what needs to be done. And I think that you will leave the hearing with substantially the goal that you may have come here to achieve: to mollify the Congress, not to say anything that would disturb the public.

But on the other hand, we have, I think, failed to address you in the private financial institutions. We in the political process of our country, as the leading institution in the world responsible for preserving order, we have failed to address and provide the inspiration, direction, and leadership necessary to maintain a sound and stable world economic order.

So long as we won't talk about it, those who can, we are not going to create the kind of consensus and direction, I think, that is necessary to provide the remedies.

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So, I appreciate your efforts that you have come here with, and I appreciate the sincerity of them. I hope that we can, some future Congress, move beyond them while we still have the chance and the opportunity.

I don't know if we have any more time. I have some questions.

You did indicate, on the question of spreads or debt burden, that it was not oppressive on the borrowing countries. It seems to me that your commentary was in conflict wth the evaluation of a recent Salomon Bros. report of April 2, 1980, of which I will read a portion to you and have you react in terms of your evaluation that the debt burden is and will continue to be serviceable by the LDC's. It says:

> In addition, a further substantial rise in the London Intelbank offer grade since the year 1979, from 14 percent last December to 19¾ percent currently, is another significant factor to be considered in the question of debt service. According to Morgan Guaranty, the interest charges on the estimated $150 billion of the bank's claims on non-OPEC LDC's at the year-end 1979, based on the annual interest payments by these countries, would increase by $1½ billion for each percentage point increase in lever. Given the contractual lending spread of 3/4 percent and prevailing lever rates, total interest payments by non-OPEC LDC's on bank debt amounts to roughly $30 billion annually.
>
> This contrasts with the circumstances following the 1973-74 oil price increase when non-OPEC LDC borrowing rose sharply, while their outstanding debt advanced to $60 billion from the end of 1975 from $33.5 billion. At the end of 1975, since lever averaged only 5 percent during 1975, and even allowing for the fact that contractual spreads are above 1¾ percent, the annual interest cost of servicing this bank debt was less than $5 billion.

They go on to say:

> Beyond these immediate concerns, a number of informed observers are of the opinion that the real price of oil will continue to rise in the years ahead, and the OPEC countries will not spend back their increased export revenues as readily as in the years immediately following the 1973-74 price increase.

I take it that you all disagree with that analysis of the increasing burden of the debt service and the projected increasing disproportion between OPEC and the LDC's?

Mr. BALATSOS. Can I take a second first? As I pointed out in my testimony, ultimately you have to have resources to service the debt. The best source for that is exports. So, by looking at the relationship of the current account deficit of the LDC's in relation to potential exports, my own projection is that the ratio will deteriorate marginally from 1979 through 1980–81. On the basis of my best-guess economic projections for the world economy.

I want to remind you that back in 1974 was a dramatic setback because exports collapsed. So, on the basis of that, I personally feel that the emphasis in the Salomon Bros. statement is perhaps on the gloomier side, and I would like to refer to Mr. Heller's points earlier, that we have seen a very significant increase in LDC reserves in the last couple of years, which earn interest.

Mr. HELLER. Just a quick followup. The numbers that the report mentioned were something in the neighborhood of $30 billion to approximately $70 billion in outstanding debt. That compares to foreign exchange reserves in 1974 of $35 billion, and in 1979 of $81 billion.

So, you have very much of a parallel movement. And as I pointed out before, there is interest earned on these foreign-exchange reserves. It's very much the same, very closely linked to the interest

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rate paid, because both of them move very much with the Euromarkets.

So, while there are interest-sensitive assets and liabilities, they tend to offset each other as far as the effect is concerned. Therefore, by looking at only one side of the balance sheet, I think you get a somewhat more alarmist picture than if you look—as is appropriate, I would say—at both sides of the balance sheet.

Mr. CAVANAUGH. Do you feel that the Salomon report is also excessively alarmist as it projects conditions into 1981–82? And this will be my last question, Mr. Chairman. But the report goes on to state that:

> To the extent that a shortfall develops between private and official capital flows, it will be most likely formed by the domestic economies of the Third World. In our judgment, the rate of economic adjustment in a number of these countries, including several of the more industrialized nations, will probably not be rapid enough to avoid debt reschedulings. Therefore, over the period 1980–82, it is our expectation that the amount of rescheduling will be far greater and considerably more difficult than in the 1976–79 interval.

Are you anticipating that the reschedulings will be far greater in the 1980–82 period than we did experience in the 1976–79 period? Greater or less?

Mr. BALATSOS. I hope you appreciate that this is a guess. My guess is that they will not be greater.

Mr. VAGLIANO. I don't think they will be far greater. Again, I think we come back to the uncertainty of what happens in the industrial world and the reaction to LDC exports. If the industrial world really slows down and you have a big dropoff in exports from the LDC's, then the problem will be there.

I think that one of the things that is troublesome, of course, is that when we speak of adjustment, it is easy to speak of adjustment, but basically adjustment means a smaller rate of growth. Many of us who have been involved in economic development and economic decisions of the LDC's, over a long period of time always find that to be discouraging, when I think a good many of the LDC's have shown real progress in their economic and social evolution and have been helped basically intelligently, by the industrial world—though perhaps not enough.

We are now in a period of time when politically it's going to be difficult for the industrial countries, with their own problems, to increase their own contributions. It again comes back to the importance of eventually having greater contributions from the OPEC countries.

Mr. CAVANAUGH. I think that is an astute commentary and one which causes me tremendous alarm, as I see this Congress is almost unwilling to continue our participation in the international development banks altogether. The legislation that we had on the floor cut the Asian Bank by 60 percent, or the Inter-American Bank by 60 percent, the Asian Bank by 40 percent.

Yet we have this tremendous growing demand. This legislation is going to have a very difficult time getting through, and even if it does, I think, given the magnitude of the imbalances that the world is confronting, it is going to severely strain the IMF's capability to meet those.

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The thing that really disappoints me is the commercial banks' inability—and maybe I am not questioning your integrity, but from my perspective, to be candid—and the more limited ability or willingness or appropriateness that you are going to play in the recycling process in the next 2 years, if in fact the lower 30 or 40 countries—I had dinner with the chairman the other night and Mr. Rosiere—are economic basket cases, perpetual wards of the world, if you will. They are going to be cut off from significant or adequate public financing, cut off from private financing. What are going to be the social and political consequences for that?

The fact is, we are providing no answers for that. Now you as commercial bankers may be insulated from the consequences for some period of time, but not for very long. We as a nation may be able to sustain those consequences for some period of time, but not for very long.

But we together are not creating an international structure that allows us to address them. And again, just in closing, what you have said to us here today is, if the world goes on and continues to function basically stably, that the structures will be able to accommodate that as they have in the past. But what I am addressing is that if they don't, can the IMF as currently constituted serve as the international monetary system and maintain stability in the face of some significant disruption? And are we creating a structure that is capable of doing that?

Because it seems to me that when Bretton Woods was created, that was the premise on which it was created, not to keep the world functioning on a day to day basis, but to have a structure that will be able to accommodate and react in the face of disruption. The IMF doesn't have that capability today. There is no international monetary system operating that has that capability, and we are going on a wish and a prayer.

Unfortunately, too much of the testimony is, the answer to that is to keep wishing and praying, rather than to address or to attempt to address the structural difficulties.

But I thank you for your contribution to the Congress today. And hopefully, it facilitated at least this legislation, if not the salvation of the world.

Mr. HELLER. Mr. Cavanaugh, if I may respond just very briefly to some of your comments. First of all, many thanks for your kind words about Bank of America.

But let me respond to your point, as I think you put it, that we are maybe not candid enough, because we are trying not to endanger our own exposure, our own participation in the international lending process.

I think here it is really important to point out that there is nothing that forces a bank into the international business. That is a completely voluntary act. We would not undertake that voluntary act if we would not think that it would be in the interests not only of the bank and the stockholders, but also of the communities that we are serving, here as well as abroad.

So it is a voluntary decision, and in that sense we are not in a box that we can't get out of. Over a certain period of time, we could certainly concentrate back on California business and hopefully U.S. business and live happily ever after.

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But beyond that, I think we do have a commitment to the international community. We do have a physical presence in something like 120 countries. We do have staff over there. We employ a vast number of nationals of these other countries. And we think we can constructively contribute to the North-South dialog, to the relations between this country and the communities that we serve abroad.

In many cases it is a lot easier to work on the improvement of those international relations through private informal channels than through legislation. Not that legislation and official institutions do not play an important role, but there are various ways in which you can pursue that constructive dialog And we are certainly happy to be party to that dialogue and to be here for that purpose.

Mr. CAVANAUGH. I am happy that you are, and I hope that nothing that I have said here indicates that I am not for a vigorous and active role by American commercial banks in the international market. I think it is constructive and essential to your interests and to our country's interests.

But I think to simply abandon both you and the rest of the world in terms of establishing a structure in which you and everyone can survive with a reasonable degree of tranquility in the immediate years ahead—maybe I am wrong. I hope I am. And obviously you know more about it than I do. I am all for your being far more accurate than I am.

Thank you, Mr. Chairman.

Chairman NEAL. Thank you all again for coming. You have made a valuable contribution and we appreciate it.

[Whereupon, at 12:15 p.m., the hearing was adjourned.]

[The National Advisory Council on International Monetary and Financial Policies special report to the President and to the Congress on proposed increases in quotas of the International Monetary Fund of November 1979, follows:]

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APPENDIX

NATIONAL ADVISORY COUNCIL

ON

INTERNATIONAL MONETARY AND

FINANCIAL POLICIES

SPECIAL REPORT

TO THE PRESIDENT

AND TO THE CONGRESS

ON PROPOSED INCREASES IN QUOTAS

OF THE

INTERNATIONAL MONETARY FUND

November 1979

(591)

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periodic increases in its resources, in conjunction with the growth of world trade and economic activity. Its ability to meet the demands of the uncertain period ahead must be assured.

The IMF serves two basic functions for its 139 member countries: its Articles of Agreement constitute the formal rules of the international monetary system and establish member countries' obligations to promote a cooperative and stable world economic order; and its resources are available to assist members in dealing with balance of payments difficulties in a cooperative manner that respects the IMF's objectives and rules. The basic purposes of the Fund are set forth in its Articles of Agreement, and include the following:

-- To facilitate the expansion and balanced growth of international trade, the achievement of high levels of employment and real incomes, and the development of productive resources of all members;

-- To promote exchange stability and orderly exchange arrangements, and to avoid competitive exchange depreciation;

-- To assist in the elimination of exchange restrictions;

-- To assist members in correcting payments imbalances without resort to measures destructive of national or international prosperity.

As a consequence of comprehensive amendment of the IMF Articles of Agreement, which became effective in 1978, the IMF has been given major new responsibilities for the management, operation and adaptation of the international monetary system. For this purpose, the Fund is directed to exercise firm surveillance over the exchange rate policies of members; to oversee the operation of the international monetary system; and to oversee the compliance of members with their general obligations, including efforts to direct economic and financial policies toward fostering orderly economic growth with reasonable price stability and to avoid manipulating exchange rates or the system to prevent balance of payments adjustment or gain an unfair competitive advantage.

The provisions on surveillance recognize that the attainment of exchange market stability depends on development of underlying economic and financial stability in member countries. These provisions equip the IMF with major potential to address the problems of policy coordination among member nations with a view to achieving a more sustainable pattern of payments positions and a more smoothly functioning international monetary system. The IMF's focus encompasses not only exchange rate policy, narrowly defined, but also domestic

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PROPOSED INCREASE IN QUOTAS OF THE INTERNATIONAL MONETARY FUND

I. Introduction

The National Advisory Council recommends to the Presiden and to the Congress the enactment of legislation to increase the United States quota in the International Monetary Fund (IMF) from SDR 8,405 million to SDR 12,607.5 million.1/ The IMF is the world's principal source of official balance of payments financing, designed to support effective and cooperative economic programs initiated by member countries to correct their balance of payments difficulties, and thus to foster global monetary stability. The increase in the U.S. quota would be part of an overall increase in IMF quotas totaling 50 percent, from SDR 39 billion to SDR 58 billion recommended by the IMF Board of Governors on December 11, 1978 pursuant to its Seventh General Review of Quotas. The increas in quotas will constitute a permanent expansion of the IMF's resources. This increase in resources is needed to maintain the IMF's ability to meet demands during a period of rising international trade and financial transactions, and, especially, during a period of rapidly increasing global payments imbalances and potential strains on the international monetary system.

Expanded quotas will become effective when the Fund determines that members having not less than 75 percent of the total of quotas on November 1, 1978, have consented to increases in their quotas. Members are to notify the Fund of their consent to quota increases not later than November 1, 1980, provided that the Executive Board may extend this period as it may determine.

This report reviews the role and operations of the IMF; describes the current world balance of payments situation and the need for the proposed increase in quotas; reviews the functions of IMF quotas and the proposed increase in quotas; and describes the legislation proposed to give effect to the increase in the U.S. quota.

II. Role and Operations of the International Monetary Fund

An open and liberal trading and payments system which benefits U.S. interests is a key objective of U.S. foreign and domestic policy. An effective and strong IMF is vital to such a system, and helps provide the framework for continued efforts to reduce barriers to world trade and financial transactions. Maintaining a strong IMF requires

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1/ Equivalent to approximately $10.9 billion and $16.4 billion respectively, at exchange rates of November 20, 1979 (SDR 1 = $1.29702).

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periodic increases in its resources, in conjunction with the growth of world trade and economic activity. Its ability to meet the demands of the uncertain period ahead must be assured.

The IMF serves two basic functions for its 139 member countries: its Articles of Agreement constitute the formal rules of the international monetary system and establish member countries' obligations to promote a cooperative and stable world economic order; and its resources are available to assist members in dealing with balance of payments difficulties in a cooperative manner that respects the IMF's objectives and rules. The basic purposes of the Fund are set forth in its Articles of Agreement, and include the following:

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The provisions on surveillance recognize that the attainment of exchange market stability depends on development of underlying economic and financial stability in member countries. These provisions equip the IMF with major potential to address the problems of policy coordination among member nations with a view to achieving a more sustainable pattern of payments positions and a more smoothly functioning international monetary system. The IMF's focus encompasses not only exchange rate policy, narrowly defined, but also domestic

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economic policies as they affect the balance of payments adjustment process. The IMF has enhanced capability to advise not only countries in balance of payments difficulty, but also countries in surplus, on the international implications of their policies and on approaches they might appropriately follow to correct their payments imbalances -- a symmetry of approach that is essential to an effectively functioning system. The surveillance provisions and other apsects of the amendment to the IMF Articles are described in detail in a Special Report of the Council submitted to the President and the Congress in April 1976.

The basic financial resources of the IMF are provided by quota subscriptions of its members. These resources are available to support members' efforts to deal effectively and in a timely fashion with temporary balance of payments problems, while avoiding measures destructive of national or international prosperity. The IMF's operations are similar to those of a revolving fund. All members in a sufficiently strong balance of payments and reserve position are obligated to permit their currency subscriptions to be used by the IMF to finance IMF drawings by other member countries in need. All members also have the right to draw from the IMF, when in balance of payments need, on the basis of IMF policies uniformly applied to all IMF members. Drawings other than reserve tranche drawings bear short- to medium-term maturities, and are generally accompanied by policy conditions on the borrower intended to correct its balance of payments problems, and assure timely repayment to the IMF. The IMF is thus in a position given sufficient overall resources, to meet changing world payments needs and patterns. It utilizes the financial commitments of countries in strong payments positions at any particular point to provide financing to other members facing payments difficulty. Balance of payments patterns can change rapidly, and many IMF members, including the United States, have been on both sides of the ledger, providing IMF financing at times and utilizing it at others.

The IMF is authorized to borrow to supplement its normal resources, and has done so under three arrangements.

-- In 1962, the General Arrangements to Borrow (GAB) were established, under which ten major industrial member countries agreed to lend specified amounts of their currencies to the IMF in order to facilitate drawings from the IMF by any of the ten. Commitments under the GAB amount to SDR 6.5 billion (approximately $8.4 billion) at current exchange rates, of which the U.S. share totals $2 billion.

-- In 1974 and 1975, the IMF borrowed SDR 6.9 billion from a number of oil exporting and industrial countries to finance a temporary "oil facility" designed to assist countries in dealing with balance of payments problems attributable to the 1973/74 oil price increases. The oil facility ceased new operations in March 1976. The U.S. did not participate in the financing of this facility, nor borrow from it.

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-- In February 1979, the Supplementary Financing Facility (SFF) began operations on the basis of commitments from a group of industrial and oil exporting nations. The SFF provides funds to help finance IMF drawings by countries that face balance of payments needs larger than their regular access to IMF financing, and conditioned on the undertaking of corrective measures. Total commitments under the Supplementary Financing Facility amount to SDR 7.8 billion, of which the U.S. has agreed to provide up to SDR 1,450 million (but not to exceed the approximately $1.8 billion appropriated for this purpose). The Supplementary Financing Facility was originally designed as a "bridge" to the permanent increase in IMF resources through the quota expansion now proposed. New operations under the Supplementary Financing Facility are scheduled to cease within two to three years following February 23, 1979, its date of entry into force. (For further background on the Supplementary Financing Facility, see the Council's Special Report to the President and the Congress submitted in September 1977.)

The IMF's financing operations take the form of foreign exchange transactions with members. A member drawing from the IMF uses its own currency to "purchase" foreign exchange or SDRs from the IMF to help in meeting its balance of payments financing needs. A member repays the IMF either by providing reserve assets (SDRs or foreign exchange) to "repurchase" IMF holdings of its currency, or by the IMF's holdings of its currency being drawn down by other members in need. The amount of resources effectively available to the Fund to finance purchases -- the "liquidity" of the Fund -- depends not only on the size of quotas, but importantly on the composition of its currency holdings, since only the currencies of those members with a strong balance of payments and reserve position are usable in IMF operations at any particular point in time.

The IMF's basic financing operations are conducted under its "tranche" policies. Drawings in the reserve tranche (equivalent to the reserve asset portion of a member's quota subscription, plus net IMF use of the member's currency subscription) are available automatically upon the member's representation of a balance of payments need, are interest free and are not subject to repurchase obligations. Drawings in the four "credit tranches," each equal to 25 percent of the member's quota, must be repurchased within three to five years and are subject to interest charges, currently ranging from 4-3/8 percent to 6-3/8 percent. Drawings in the first credit tranche require presentation of an economic program which satisfies the Fund that the member is making

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a "reasonable effort" to solve its difficulties. Drawings in the three remaining, or "upper," credit tranches require "substantial justification" and the undertaking of specified policy conditions by the borrower. Such conditions are normally incorporated in a "standby arrangement," under which the availability of the IMF funds is phased as the member meets agreed "performance criteria." The performance criteria normally are associated with macro-economic policies, and are designed to correct the member's balance of payments problem and provide assurance of repayment to the IMF within a short- to medium-term period.

In an effort to provide members additional access to IMF resources to meet balance of payments needs arising from particular problems, the Fund presently has in existence a number of special facilities.

a) Supplementary Financing Facility (SFF): As indicated above, the SFF is a temporary supplement to regular IMF operations, designed to provide expanded financing, in conjunction with use of the IMF's regular resources, to countries experiencing severe balance of payments difficulties. A member drawing from the facility must have a balance of payments financing need that exceeds the amount available under the Fund's regular or extended facilities, and must present an economic stabilization program which satisfies upper credit tranche conditions. Drawings carry a longer repurchase period (3-1/2 to 7 years) than applies to regular "tranche" drawings, and bear interest rates keyed to the cost of funds to the IMF (i.e., the interest rate on medium-term U.S. Government securities).

b) Compensatory Financing Facility (CFF): The CFF provides additional access to IMF resources for countries experiencing payments difficulties due to temporary shortfalls in export earnings largely attributable to factors beyond their control. A member may draw up to 100 percent of quota from the CFF. Interest and repurchase provisions are the same as for regular "tranche" drawings. The member is required to cooperate with the Fund in an effort to find solutions, where required, to its payments difficulties.

c) Extended Fund Facility (EFF): The EFF provides longer-term balance of payments financing to countries undertaking comprehensive programs of structural adjustment, approved by the IMF, covering a number of years. A country may draw up to 140 percent of quota under the EFF, but not in excess of 165 percent from the EFF and credit tranches combined. Provision has also been

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made for use of the Supplementary Financing Facility to supplement financing from the EFF. Drawings from the EFF have longer repayment periods (4 to 8 years) than regular credit tranche drawings. The interest rate on EFF drawings is the same as on credit tranche drawings for the first five years, and 1/2 percent higher than the maximum rate for later years.

d) Buffer Stock Facility (BSF): The BSF assists members in financing their contributions to international buffer stocks that meet IMF criteria. The member must have an overall balance of payments need and may draw up to 50 percent of quota. The interest and repayment provisions are the same as for regular drawings.

e) Trust Fund: The Trust Fund was established in 1976 -- as a separate legal entity from the IMF, but managed by it as Trustee -- to provide balance of payments financing on concessional terms to members of the IMF with very low per capita GNP. Financing for the Trust Fund is derived from a portion of the profits on the sale of 25 million ounces of IMF gold. Trust Fund loans bear interest at one-half percent per annum, are scheduled to be be repaid over a 5 to 10 year period, and are subject to policy conditions equivalent to those applying to first credit tranche drawings.

Special Drawing Rights (SDR)

The SDR facility was created in 1969, pursuant to an amendment of the IMF's Articles, to supplement existing reserve assets. The SDR differs fundamentally from other IMF operations, in that it represents the creation of a reserve asset rather than an extension of financing by the IMF. SDRs are allocated to member countries in proportion to quota. To date, SDR 13.3 billion has been allocated, and an additional SDR 4 billion is to be allocated in both 1980 and 1981.

The IMF Articles establish the objective of making the SDR the principal reserve asset in the international monetary system. The SDR is the unit of account of the IMF, and is the preferred medium for many IMF transactions. A number of steps have been taken recently to enhance the role of the SDR, including the resumption of SDR allocations and measures to improve the financial attractiveness and usability of the SDR. The IMF is presently considering the possible establishment of a substitution account that would accept deposits of dollars and possibly other currencies in exchange for SDR-denominated

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claims, as a further step in in strengthening the role of the SDR in the international monetary system.

III. World Balance of Payments Situation and Need for Quota Increase

The adequacy of IMF resources is reviewed periodically in relation to the growth of international transactions, the scale of payments imbalances and financing needs, and world economic prospects. Despite quota increases on four occasions during the IMF's history, quotas have fallen to about four percent of annual world imports, in comparison to 8-12 percent during the decade of the 1960s and 10 to 14 percent during the 1950s.

Table 1

IMF Quotas as Percent of World Imports

	Percent
1979	4.0 (est.)
1975	4.2
1970	9.6
1965	9.1
1960	12.3
1955	9.8
1950	13.6

The proposed increase in IMF quotas would do little more than halt the decline in the relative size of IMF resources over the next five years. In contrast to the steep reduction in the relative size of the IMF, world payments imbalances and financing needs have risen dramatically during the past decade. The prospect is for continued very large payments imbalances during the period ahead, and for potentially heavy demands on the IMF's resources. This section describes developments in the world payments situation over the past several years and the major changes in the outlook that are now underway.

Global balance of payments patterns changed sharply in the aftermath of the 1973-74 increases in oil prices. The aggregate current account 1/ surplus of the oil exporting

1/ Balance on goods, services and private and official transfers.

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nations jumped from an annual average of about $2 billion during 1971-73 to an average of about $35 billion during 1974-78. The traditional current account surplus of the OECD nations as a group, which had averaged about $9 billion during 1971-73, shifted sharply into deficit, averaging about $12 billion during the following 5 years. The current account deficit of the non-oil exporting developing nations widened substantially, from about $7 billion per year in 1971-73 to an average of $20 billion during 1974-78.

International financing requirements also increased sharply between the two periods, not only as a direct consequence of the imbalances caused by the oil price increases, but also becaus of imbalances attributable to large disparities in national economic performance that characterized much of the 1970's; rapid escalation of prices worldwide; and the general increase in the scale of world trade and economic activity. Aggregate net balance of payments financing requirements for all countries in deficit averaged approximately $19 billion during 1971-73; during the following five years, average annual current account deficits rose to about $77 billion -- with net external financing needs totaling $385 billion over the five-year period as a whole.

Table 2

Global Payments Patterns
Current Account Balances
($ Billions)

	Annual Average	
	1971-1973	1974-1978
Total Deficits:	19	77
OPEC	1	6
OECD	7	37
LDC	8	23
Other	3	11
Total Surplus:	20	69
OPEC	3	41
OECD	16	25
LDC	1	3
Net:		
OPEC	+2	+35
OECD	+9	-12
LDC	-7	-20
Other	-3	-11
Residual	-1	+8

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The changes in world financing requirements outlined above placed enormous demands and, at times, strains on the international financial system. Official financing through the IMF during this period was far above historical levels. Notwithstanding this activity and substantial growth in official development lending, the private markets provided the bulk -- about three-quarters -- of total current account financing during the five-year period.

Complementary to expanded demands for credit, conditions on the supply side of the market were also conducive to a rapid growth in private financing during the period. OPEC's large, investible surpluses -- as well as those of several oil-importing nations later in the period -- brought large deposits and placements to recipient banks and other financial intermediaries. The elimination of U.S. capital controls in January 1974 fostered expansion of U.S. lending abroad, and the period was one of rapid expansion of the international banking system. With domestic loan demand in the major countries much weaker during 1974-75 than in immedfately preceding years, many institutions were competing actively for new customers abroad.

Using such data as are available -- and acknowledging that the picture is incomplete -- the pattern of the financing of world payments in the period 1974 through 1978 had roughly the following dimensions:

-- The cumulative net financing requirement for countries in current account deficit (after net receipt or payment of official transfers) equaled about $385 billion. This represented the counterpart of the investible surpluses of OPEC countries plus those of certain industrial and other developing countries registering surpluses during the period.

-- About $15 billion of these requirements, or four percent of the total, was met by the IMF, the bulk of it through the temporary Oil Facility and the Compensatory Financing Facility, both of which provided financing largely on the basis of "need" with relatively little emphasis on "conditionality" or the adoption of corrective adjustment measures by the borrower.

-- About $70 billion of the financing requirment, or nineteen percent of the total, was met by a variety of other official sources -- development lending by industrial and OPEC countries, by the IBRD and regional development banks, and by other official financing.

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-- The remaining requirements, some $300 billion, were met largely through market-oriented borrowing. Most of these funds were obtained through banks and securities markets.

Increased financing, of course, resulted in higher levels of external indebtedness. For the non-OPEC developing countries, the growth in foreign debt was very rapid relative to earlier trends. Specifically, the external public debt of 79 of these countries which have borrowed from the IBRD rose from about $50 billion at the end of 1972 to more than $175 billion at the end of 1978 -- an average annual increase of 23 percent over this six-year period. While the burden of servicing the debt has increased since 1972, it has remained manageable because the export earnings of these countries increased rapidly and they were able to maintain rates of economic growth above five percent per year throughout the period. The aggregate "debt-service ratio" for the non-OPEC developing countries was somewhat higher at the end of 1978 than at the end of 1972. However, the distribution of the debt suggests that it is falling most heavily on those countries that have the greatest capacity to bear it, and whose economic prospects are the brightest. In the period since 1972, ten of the non-OPEC developing countries obtained debt relief through multilateral negotiations with their official creditors.

Initially in the wake of the first oil price increases, major emphasis was placed on financing the major deterioration of the current account position of the oil importing world. At the time of the initial shifts in payments patterns, there were serious concerns that the oil importing nations, trying individually to protect their own payments positions, would harm themselves and each other by external restrictions and excessive domestic retrenchment as they tried to eliminate deficits which collectively -- as the counterpart of the OPEC surplus -- could not be eliminated. Recognizing these dangers, the IMF membership agreed in January 1974 in the Rome Communique of the Committee of Twenty to foreswear such self-defeating actions.

Accordingly, in the early aftermath of the oil price increases, emphasis was appropriately placed on assuring the adequacy of resources for financing the balance of payments costs of higher oil prices. Nations were encouraged, at least temporarily, to "accept" the oil deficit and finance it, rather than to try individually to eliminate their respective deficits at the expense of other oil importing countries. Most of the financing made available -- both by private and official sources -- was essentially without

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policy conditions or requirements that particular adjustment policies be implemented. IMF resources were expanded by creation of the temporary Oil Facility, and other IMF facilities, such as the Compensatory Financing Facility, the Extended Fund Facility and the Trust Fund, were expanded or created to provide greater access to countries facing particular balance of payments difficulties. Annual drawings from the Fund rose from small amounts during the 1971-73 period to a record high of about SDR 7 billion ($9 billion) in 1976, by which time total IMF credit outstanding amounted to SDR 12.6 billion ($16.4 billion).

Table 3

IMF Drawings and Credit Outstanding
(SDR Billion)

	Gross Drawings	Credit Outstanding [a/] (end of period)
1979 (to Sept. 30)	1.4	8.1
1978	3.7 [b/]	10.3
1977	3.4	13.1
1976	7.0	12.6
1975	4.7	7.4
1974	4.1	3.7
1973	0.7	1.0
1972	1.6	1.1
1971	1.9	1.3
1970	1.5	3.2

a/ Net use of IMF credit (excludes reserve tranche drawings).
b/ Includes U.S. reserve tranche drawing of SDR 2.3 billion in November 1978.

The availability of financing during the early years following the 1973-74 oil price increases provided countries with time and the opportunity to reassess their overall economic policies in light of fundamentally altered economic circumstances. With such financing, countries did not have to move abruptly to reverse the weakening of their current acount positions, because of a lack of financing. There was growing recognition on the part of many countries, however, that basic adjustments would ultimately be required to bring their own positions, and the system as a whole, into sustainable balance. The IMF began to place greater emphasis on the need for balance of payments adjustment, in combination with provision of adequate financing to support sound and cooperative economic stabilization programs.

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In part as a result of the greater emphasis placed by the international community on adjustment, the distribution of world current account balances in 1978 underwent the most important changes since the 1973-74 oil crisis. The OPEC current account surplus fell sharply to approximately $3 billion for the year as a whole, and was close to zero during the second half. The OECD countries moved into moderate surplus as a group, while the non-oil LDCs experienced a modest increase in their combined deficit position.

The pattern of IMF financing also shifted during the period. In 1974-76, net drawings by deficit countries (i.e., gross drawings, including reserve tranche drawings, less repurchases) amounted to a record $15 billion. The OECD countries accounted for about $9.5 billion, or 64 percent, of the total, and developing countries $5.4 billion, or 36 percent. In 1977 and 1978, the use of IMF resources by deficit countries (excluding the U.S.) slowed considerably. In part, this reflected the successful stabilization efforts of some countries -- both developed and developing -- and the increased availability of financing from other sources. New drawings totalling about $2.9 billion in the two years were offset by repayments of outstanding drawings of roughly the same magnitude. However, the area pattern of use of IMF resources also shifted, with the developing countries having net drawings of $440 million in 1977-78, while OECD countries made net repurchases of about $460 million. In addition, drawings from the regular credit tranches were the predominant source of IMF financing, in contrast to the relatively heavy emphasis placed on drawings from less conditional facilities in the earlier period.

Even with important improvements in the distribution of imbalances among the major country groups, large and unsustainable imbalances within the groups, particularly the imbalances of the United States, Japan and Germany, continued to be a source of strain on the international monetary system. Total international financing needs consequently remained at very high levels. Serious exchange market pressures developed in the fall of 1978. As part of a comprehensive program to help stabilize the markets and strengthen the dollar announced on November 1, 1978, the United States drew the equivalent of $3 billion, in German marks and Japanese yen, under its reserve tranche position in the IMF, and sold the equivalent of $1.4 billion of special drawing rights for the same currencies.

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By the end of 1978, imbalances among the key industrial countries were clearly being reduced. Trends during 1979 have confirmed this, and exchange market conditions have improved. For a short period toward the end of 1978 and early 1979, the prospect was for a more stable and sustainable pattern of world payments positions, and for a substantial decline in net international financing requirements.

Recent oil market developments have once again radically altered economic prospects, and thrown the world into a pattern of payments imbalances reminiscent of that following the 1973-74 price increase. By November 1979, official OPEC oil prices had increased roughly 65 percent over December 1978 levels, and major uncertainties and concerns had arisen over constraints on future oil supplies. As a consequence of the major increase in oil prices this year, it is estimated that the combined current account surplus of the OPEC nations will rise to about $60 billion in 1979, in sharp contrast to the near balance recorded in 1978. The current account position of the OECD nations as a group will deteriorate by roughly $40 billion in 1979, from modest surplus to large deficit. And the current account deficit of the non-oil exporting developing nations is likely to rise by more than $10 billion. Large imbalances will continue, and in some cases deteriorate, in 1980.

The increases in oil prices have seriously worsened the outlook for global economic growth, and have produced a surge of world inflation pressures and inflationary expectations. Oil prices continue to escalate; and uncertainties over energy supplies, combined with the steep increase in the relative cost of energy as a factor input, may well result in lower-than-desired rates of real growth throughout the world economy over the medium-term.

With the increase in oil prices thus far in 1979, it is anticipated that global financing requirements will increase to something on the order of $90 billion this year and next. Even in the absence of further major oil price increases, which cannot be assumed with assurance, it must be anticipated that large payments imbalances and consequent financing needs will persist during the next several years; efforts to adjust imbalances will be made more difficult by a world environment of slower growth, continued inflationary pressures, and energy supply constraints. It is critically important to the health of the world economy that the system be adequately equipped to meet such financing needs as may arise.

As indicated above, the private markets provided the bulk of global financing required in the wake of the 1973-74 oil price increases, and the private sector will again be required to meet the bulk of expanded financing

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demands in the period ahead. Flows of official development assistance will continue to rise, helping to offset the deterioration in current account position for a large number of developing countries. But, particularly in light of the very large amounts of financing provided in the last several years, it must be anticipated that some individual countries developed and developing -- will encounter financing -- difficulties, and will need to undertake efforts to restore stability to their domestic economies and bring their external positions into line with sustainable flows of financing. An inability to obtain financing from the markets, or through development assistance, in needed amounts and on acceptable terms, may cause some countries to turn to unduly restrictive domestic economic measures, and could be tempted to apply trade and capital restrictions, or aggressive exchange rate practices in order to reduce their financing needs. Such measures could have serious repercussions worldwide and for the economy of the country introducing them. In today's interdependent world, the economic actions and policies of one country are closely related to those of other countries and directly affect their economic prosperity. Trade barriers imposed by one country, for instance, can abruptly and seriously impair other countries' trade and payments positions, and lead them in turn to impose barriers in order to protect their own external positions or in retaliation.

The potential for serious disruption of the world economy is widely recognized. The U.S. economy, for example, is heavily dependent on world trade and financial flows. Imported products, from raw materials to high technology products, are heavily integrated into all phases of U.S. economic activity. Export markets constitute a major source of demand for U.S. goods and services. U.S. financial markets play a critical role in international financial transactions. It is of critical importance to the prosperity of the U.S. economy specifically, and the world economy generally, that the structure of the international financial system remain sound and that the liberal system of world trade and payments be maintained.

A combination of appropriate adjustment measures, accompanied by adequate financing, is needed to assure a smoothly functioning and cooperative international monetary system. The IMF is the world's central source of official balance of payments financing. In a very real sense, it serves as the financial backstop for the system, as a lender of last resort for countries experiencing balance of payments difficulties, and as a source of encouragement for countries to pursue timely and appropriate measures to correct their balance of payments difficulties. As world balance of payments patterns and problems have changed, the IMF has expanded its facilities and modified its financing policies

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to meet the evolving needs of its members. Moreover, in part as a result of the fall-off in net use of IMF credit in the past two years, the IMF should -- with the expansion of quotas here recommended -- be in a relatively strong position to meet the enlarged demands that must be anticipated over the next few years in light of growth in the world economy and major alteration of the world payments situation.

Current IMF holdings of "usable" currencies 1/ amount to the equivalent of about SDR 10-12 billion. These holdings are supplemented by amounts remaining available under the General Arrangements to Borrow (about SDR 5.7 billion) and the Supplementary Financing Facility (about SDR 7.5 billion). The Supplementary Financing Facility is scheduled to cease new operations in early 1981, or possibly early 1982. IMF quotas, representing the IMF's permanent resource base as well as the basis for determining members' access to those resources, have shrunk dramatically over the years in relation both to world trade (Table 1) and to global balance of payments financing needs. The IMF's available resources, while substantial in absolute terms, are very small in comparison with prospective world financing needs and the requirements that may arise for official balance of payments financing.

A further review of IMF quotas is not scheduled to take place until December 1983, and implementation of any expansion of quotas that might be agreed at that time would be likely to take another 1-1/2 to 2 years. Thus, as a practical matter, the increase in quotas now proposed will have to suffice for approximately five years. It is clear that this may be a period of serious strain and difficulty for the international monetary system, and that the scale of international trade and other transactions will in any case rise substantially over a five-year period. It is essential that the IMF be in a strong position to meet the needs that may arise and to provide confidence that the official underpinnings of the system are strong.

IV. Proposed Increase in IMF Quotas

Quotas play a central role in the IMF. Members' quota subscriptions constitute the IMF's permanent financial resources, and members receive in exchange for their subscriptions certain rights, including the right to draw on IMF resources to meet a balance of payments need. The amount

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1/ IMF holdings of the currencies of countries that are in a strong enough balance of payments and reserve position for their currencies to be used in financing IMF drawings by other members.

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of funds a member may draw from the IMF is determined in relation to its quota. Quotas provide the distributional basis for SDR allocations. And, of key importance in any IMF quota negotiation, quotas determine voting power and thus influence over IMF decisions, not only on financing operations, but also on implementation or modification of the IMF rules relating to the operation of the international monetary system.

Article III, Section 2 of the Articles of Agreement of the IMF provides: "The Fund shall, at intervals of not more than five years, conduct a general review, and if it deems it appropriate propose an adjustment of the quotas of members." An 85 percent majority of the total voting power is required for any change in quotas proposed as the result of a general review, and no quota can be changed without the consent of the member concerned. Under these provisions, the first increase in quotas took place in 1958-59, a general increase of 50 percent, raising quotas from $9.2 billion to $14.3 billion. Also as a part of the 1958-59 review, there were a number of selective adjustments to individual country quotas, permitting increases larger than 50 percent, to achieve a more satisfactory relative position among member countries, and to take into account changes in relative positions of different parts of the world that had taken place since initial quotas were established in 1944. The U.S. quota was increased from $2.8 billion to $4.1 billion.

The second increase in quotas took place in 1965-66, a 25 percent enlargement of total Fund quotas. In parallel with this general increase, 16 member countries received quota adjustments of larger percentages. These selective adjustments provided the Fund with additional resources in the currencies of Germany, Canada, and Japan. The U.S. quota was increased from $4.1 billion to $5.2 bilion.

In 1970, Fund quotas were increased by about 35 percent, from $21.3 billion to $28.9 billion. At this time, the IMF undertook a major readjustment of the relative quotas, since a large number of countries that had not, in the past, taken full advantage of their potential for quota increases decided to do so. The U.S. quota was increased from $5.2 billion to $6.7 billion. The IMF introduced the SDR at about this time, at par with the dollar, so that the SDR value of the U.S. quota was the same as the dollar value of the U.S. quota, i.e., SDR 6.7 billion.

The fourth increase in quotas was implemented in 1978, in conjunction with a comprehensive amendment of the IMF Articles of Agreement. As part of this increase, raising total quotas by about one-third, from SDR 29 billion to SDR 39 billion, the quota shares of oil exporting nations

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doubled, reflecting their increased share of world trade, finance and economic activity. To accommodate this increase, the quota share of the developed IMF member nations as a group fell by about 4 1/2 percentage points. The U.S. quota was increased from SDR 6,700 million to SDR 8,405 million, resulting in a modest reduction in the U.S. quota share and voting share. The United States accepted this reduction in light of amendments to the IMF Articles of Agreement relating to voting majorities required for key decisions, which effectively preserved the U.S. voting position.

In January 1975, the Interim Committee of the IMF reached an understanding, as part of other agreements being negotiated at that time, that the Seventh General Review of Quotas should be completed by February 8, 1978. In the event, agreement was not reached until October 1978. At that time the Interim Committee recommended the presently proposed increase in quotas, and requested the Executive Board to prepare a proposed Resolution to be submitted to the Board of Governors. The Resolution was adopted by the Governors on December 11, 1978. The texts of the report of the Executive Board to the Governors and the Resolution are attached as Appendices A and B. Under this resolution, total IMF quotas will be increased by 50 percent, from about SDR 39 billion to about SDR 58 billion. The increase proposed for the U.S. quota is SDR 4,202.5 million, from SDR 8,405 million to SDR 12,607.5 million. Increases in the quotas of most countries will be equi-proportional, 50 percent, with a very few countries receiving modest selective increases on the basis of relative increases in their positions in the world economy. In accordance with the amended Articles of Agreement and pursuant to the Governors resolution, members which participate in the Special Drawing Rights department will pay 25 percent of the quota increase in Special Drawing Rights, and non-participants will pay the equivalent of 25 percent of their quota increases in the currencies of other members specified by the Fund. Thus all members will provide at least 25 percent of their quota increase in the form of reserve assets. The remainder will be provided in members' own currencies.

V. Proposed Legislation

Prior Congressional approval for an increase in the United States quota in the Fund is required by Section 5 of the Bretton Woods Agreements Act, as amended. The bill proposed for this purpose would authorize the U.S. Governor of the Fund to consent to an increase of SDR 4,202.5 million in the U.S. quota in the Fund, to such extent or in such amounts as are provided in appropriations Acts. This language would

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be included in the proposed bill to provide flexibility for the Administration and the Congress to change the budgetary treatment of the U.S. quota in the Fund. The proposed bill would leave the precise form and manner in which the quota increase would be reflected in the fiscal year 1981 federal budget to be developed in consultation with interested committees of the Congress.

The United States quota in the IMF is denominated in Special Drawing Rights (SDR), the unit of account of the IMF in which all members' financial rights and obligations are established. The SDR is based on the exchange value of a basket of 16 currencies. Its U.S. dollar and foreign currency value fluctuates daily with fluctuations in exchange rates. Consequently, a fixed U.S. dollar value cannot be determined for the U.S. quota increase until the date the quota increase takes effect in the Fund (which requires consent to quota increases by members having not less than 75 percent of the total quotas of the Fund). The authorization for U.S. consent to the quota increase therefore would be expressed in SDR.

VI. Recommendation

The International Monetary Fund is the central vehicle of U.S. policies to maintain a strong, open and cooperative world economic and monetary system, both through its rules relating to the conduct of international monetary relations and through its provision of financial support to countries in balance of payments difficulty. The United States it itself has on a number of occasions drawn foreign currencies from the IMF, most recently in connection with the program of operations to stabilize exchange markets announced on November 1, 1978. The resources of the IMF have not kept pace with the expansion of the world economy. A major expansion of balance of payments financing needs is in prospect, and the world economy is undergoing a period of pronounced uncertainty and change. It is essential that the IMF remain in a position to support the international monetary system during this period of potential strain, and reduce any risk that the system may not be able to meet the demands placed upon it. Accordingly, the Council strongly recommends the enactment of legislation to enable the United States to consent to the proposed increase in the United States quota in the IMF.

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ANNEX A

INTERNATIONAL MONETARY FUND

Increase in Quotas of Fund Members - Seventh General Review
Report of the Executive Directors to the Board of Governors

1. Article III, Section 2(a) of the Articles of Agreement provides that "The Board of Governors shall at intervals of not more than five years conduct a general review, and if it deems it appropriate propose an adjustment, of the quotas of the members. It may also, if it thinks fit, consider at any other time the adjustment of any particular quota at the request of the member concerned." This report and the attached Resolution on increases in quotas under the current, i.e. the seventh, general review are submitted to the Board of Governors in accordance with Article III, Section 2.

In their Resolution of March 22, 1976, the Board of Governors decided that "The seventh general review of quotas should be completed by February 9, 1978'. The review was not completed by that date. At its meeting in Mexico City in April 1978, considerable progress was made by the Interim Committee toward achieving a consensus on the Seventh Review as reflected in the communique issued at the end of its meeting on April 30, 1978.

2. At the last meeting of the Interim Committee in Washington in September 1978, understandings were reached on all major issues of the Seventh Review, as reflected in the relevant passages from the Committee's communique of September 24, 1978, as follows:

> "The Committee resumed its discussion of the Seventh General Review of Quotas and considered three major issues relating to it: the size of the overall increase in quotas, selective quota adjustments, and the method of payment of the increases in quotas. These issues were considered by the Committee in conjunction with the various issues relating to the SDR with which they are regarded as interrelated The Committee recalled its view that there was a need for an increase in total quotas under the Seventh Review that would be adequate to meet the expected need for conditional liquidity over the next five years. The Committee also recalled its view that an adequate increase would strengthen the available sources of balance of payments financing by enhancing the ability of the Fund to provide such financing without heavy recourse to borrowing and by furthering the process of international adjustment.
>
> The Committee's view was that an increase in the overall size of quotas of 50 per cent would be appropriate to bring about a better balance between the size of the Fund's resources and the need of members for balance of payments financing over the medium term. The Committee noted that the Executive Board does not intend to propose a general adjustment in quotas for five years after the Board of

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Governors approves the increase in quotas under the Seventh Review, unless there is a major change in the world economy and its financing needs.

The Committee noted with satisfaction that agreement had been reached on selective quota increases for 11 developing member countries: Iraq, Iran, Korea, Kuwait, Lebanon, Libya, Oman, Qatar, Saudi Arabia, Singapore, and United Arab Emirates.

Taking into account the conclusions reached on the issues relating to SDRs, including allocations of SDRs, the Committee was of the view that, for the quota increases proposed as a result of this review, participants in the Special Drawing Rights Department should pay 25 per cent of the quota increase in SDRs and that nonparticipants should pay the equivalent of 25 per cent of the increase in foreign exchange.

The Committee agreed to request the Executive Board to prepare and complete by November 1, 1978, for final decision and vote by the Board of Governors before the end of the year, a proposed resolution on increases in the quotas of members, which would include necessary provisions dealing with participation, the effective date of quota increases, and the method of payment of the increases in accordance with the understandings reached in the Committee."

The communique also included the following passage:

"The Committee reached the conclusions ...[on the issues related to SDRs]... with the understanding that these conclusions are interrelated and must be adopted in their entirety together with the understandings reached by the Committee on the Seventh General Review of Quotas. In the view of the Committee, therefore, decisions on all these issues relating to SDRs and on the Seventh General Review should be taken at the same time."

3. The Executive Board has considered a number of factors, both of a qualitative and quantitative nature, that affect the expected need for conditional liquidity and the Fund's ability to finance that need over the medium term without heavy reliance on borrowing. One factor is the extent of the growth o and possible fluctuations in, the value of international transactions another factor is the likely continuation of relatively large payments imbalances for many countries in the next few years. In these circumstances, the demand for balance of payments financing may well rise, and the Fund's resources should be sufficient to permit the Fund to finance a reasonable share of that demand.

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Furthermore, the Executive Board, while acknowledging the contribution made by the international capital markets to the effective functioning of the international monetary system over the last few years, believes that an increase in Fund quotas can promote the process of international adjustment in ways that could not be achieved through the private markets. The Fund provides its members with balance of payments financing on the understanding that these members will follow appropriate policies of economic adjustment. In these circumstances members' access to the Fund's resources must be sufficiently large to induce members with substantial balance of payments needs to use those resources and to pursue economic policies and programs which the Fund is able to support. While access to the Fund's resources in terms of quota is now considerably in excess of the traditional policy norm of 100 per cent of quota under the credit tranche policy, the ratio between access to Fund credit and payments imbalances is considered to be lower than a decade ago.

In recent years, the Fund has established or expanded a number of special facilities to help deal with certain balance of payments problems of its members. Some of them, notably the Extended Fund Facility and the expanded Compensatory Financing Facil ty which are of a continuing character, have increased access to Fund resources in relation to quota without additional financing being ava lable to the Fund. On the other hand, borrowing by the Fund for the Oil Facilities of 1974 and 1975 and the Supplementary Financing Facility, which is expected to come into operation shortly, entailed, or will entail, the creation of claims on the Fund's general resources which are encashable on demand if a lender has a balance of payments need. Moreover as was the case with the Oil Facilities, the resources provided under the Supplementary Financing Facility will augment members' access for a limited period of time only. At the end of that per od the Fund will be faced with both a reduction in the resources available to meet the needs of members and possibly large liquid liabilities relative to its quotas.

In view of the possibility of large payments imbalances over the next few years and the distribution of such imbalances, the Fund's liquidity position is l kely o be vulnerable, even though the volume of usable currencies available to the Fund has recently increased. Resources made available through increases in quotas give the Fund a more assured access to resources than borrowing.

In light of the above considerations, the Executive Board is of the view that, in general, increased access to the Fund's resources should, over the longer run, normally result from an increase in Fund quotas.

4. For these reasons, and in accordance with the understandings reached by the Interim Committee at its meeting on September 24, 1978, the Executive Board now proposes to the Board of Governors increases in Fund quotas of 50 per cent for most members and special increases for 11 members. The Executive Board does not intend to propose a general

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adjustment of quotas for five years after the Board of Governors adopts this Resolution, unless there is a major change in the world economy and its financing needs.

5. The Executive Board will review the customary method of calculating quotas after the Seventh General Review of Quotas has been completed. In the context o the next general review of quotas, the Executive Board will examine the quota shares of members in relation to their positions in the world economy with a view to adjusting those shares better to reflect members' relative economic positions while having regard to the desirability of an appropriate balance in the composition of the Executive Board.

6. Under the proposed Resolution, a member will be able to consent to the increase in its quota at any time on or before November 1, 1980. Therefore, unless this period is extended by the Executive Board, members will have until November 1, 1980 to take whatever action may be necessary under their laws to enable them to give their consent.

7. It is proposed that the increase in a member's quota will take effect on the latest of the following three dates:

(a) The date on which the Fund receives the member's consent to the increase in quota;

(b) The date of the payment of the increase in subscription; and

(c) The date on which the Fund determines that the participation requirement in paragraph 2 of the proposed Resolution has been satisfied. The proposed Resolution provides, however, that i the participation requirement in paragraph 2 has not been met by June 30, 1980, no increase in quotas under the Seventh Review would become effective until after October 5, 1980, so that there would be no changes in quotas during, or shortly before, the 1980 Annual Meeting of the Board of Governors, when the next election of Executive Directors will take place. If the participation requirement were met during the period July 1 to October 5, 1980, increases in quotas would become effective only after October 5, 1980.

The participation requirement in paragraph 2 is reached when the Fund determines that members having not less than 75 per cent of the total of quotas on November 1, 1978 have consented to increases in their quotas. In determining whether this degree of participation has been reached, the Fund will take into account all consents to increases, whether they are increases to the maximum amount provided for or to a smaller amount.

8. The proposed Resolution does not provide for increases in quotas by fixed installments. A member will be able, however, to consent to an increase smaller than the maximum provided for. The member will be

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able to consent to further increases, up to the maximum provided for, at a later date, provided it is within the period for consent under paragraph 3 of the proposed Resolution.

9. The proposed Resolution provides that a member must pay the increase in its subscription within 30 days after (a) the date on which the member notifies the Fund of its consent, or (b) the date on which the participation requirement is met, whichever is the later.

10. Reflecting the understandings reached at the September 1978 meeting of the Interim Committee, 25 per cent of the increase in quotas proposed as a result of the current review should be paid in SDRs for those members that are participants in the Special Drawing Rights Department, and 25 per cent of the increase in the quotas of nonparticipants should be paid in the currencies of other members specified by the Fund, subject to their concurrence. The balance of the increase shall be in a member's own currency. These payments are in accordance with the prescription of Article III, Section 3(a), and therefore it is not necessary to include any provision for the payment of increases in the Resolution.

11. In accordance with paragraph 3 of the Interim Committee's communique of September 24, 1978, the Executive Board has taken decisions on aspects of the special drawing right that are referred to in paragraph 5 of that communique. These decisions will become effective on the dates referred to in them if the proposed Resolution and the Resolution on allocations of SDRs become effective. The proposed Resolution provides that it will become effective if it and the proposed Resolution on the Allocation of Special Drawing Rights are adopted by the necessary majority of the total voting power for each.

12. The Executive Board recommends adoption of the attached Resolution. The attached Resolution is designed to enable the Board of Governors to vote at one time on all matters connected with the increases in quotas under the Resolution.

Attachment

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ANNEX B

Increases in Quotas of Fund Members—Seventh General Review

Resolution of the Board of Governors 1/

WHEREAS the Executive Board has submitted to the Board of Governors a report entitled "Increases in Quotas of Fund Members—Seventh General Review" containing recommendations on increases in the quotas of individual members of the Fund; and

WHEREAS the Executive Board has recommended the adoption of the following Resolution of the Board of Governors, which Resolution proposes increases in the quotas of members of the Fund as a result of the Seventh General Review of Quotas and deals with certain related matters, by vote without meeting pursuant to Section 13 of the By-Laws of the Fund;

NOW, THEREFORE, the Board of Governors hereby RESOLVES that:

1. The International Monetary Fund proposes that, subject to the provisions of this Resolution, the quotas of members of the Fund shall be increased to the amounts shown against their names in the Annex to this Resolution, provided that any member may consent to an increased quota that is smaller than the one shown in the Annex, and may consent thereafter to further increases that raise its quota to the amount shown against its name in the Annex not later than the date prescribed by or under paragraph 3 below.

2. A member's increase in quota as proposed by this Resolution shall not become effective unless the member has notified the Fund of its consent to the increase not later than the date

1/ Board of Governors' Resolution No. 34-2, effective December 11, 1978.

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prescribed by or under paragraph 3 below and has paid the increase in quota in full, provided that (a) no increase in quota shall become effective before the date of the Fund's determination that members having not less than three-fourths of the total of quotas on November 1, 1978 have consented to increases in their quotas, and (b) if the determination has not been made before July 1, 1980, no increase in quota shall become effective until after October 5, 1980.

3. Notices in accordance with paragraph 2 above shall be executed by a duly authorized official of the member and must be received in the Fund not later than November 1, 1980, provided that the Executive Board may extend this period as it may determine.

4. Each member shall pay to the Fund the increase in its quota within 30 days after the later of (a) the date on which it notifies the Fund of its consent or (b) the date of the Fund's determination under paragraph 2 above. If this determination is made in the period between July 1 and October 5, 1980, for the purpose of this paragraph it shall be deemed to have been made on October 5, 1980.

5. This Resolution shall become effective if it and the Proposed Resolution on Allocations of Special Drawing Rights in the Third Basic Period are adopted by the necessary majority of the total voting power for each.

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ATTACHMENT I
ANNEX B

		Proposed Maximum Quota (In millions of SDRs)
1.	Afghanistan	67.5
2.	Algeria	427.5
3.	Argentina	802.5
4.	Australia	1,185.0
5.	Austria	495.0
6.	Bahamas	49.5
7.	Bahrain	30.0
8.	Bangladesh	228.0
9.	Barbados	25.5
10.	Belgium	1,335.0
11.	Benin	24.0
12.	Bolivia	67.5
13.	Botswana	13.5
14.	Brazil	997.5
15.	Burma	109.5
16.	Burundi	34.5
17.	Cameroon	67.5
18.	Canada	2,035.5
19.	Central African Empire	24.0
20.	Chad	24.0
21.	Chile	325.5
22.	China, Republic of	550.0
23.	Colombia	289.5
24.	Comoros	3.5
25.	Congo, People's Republic of the	25.5
26.	Costa Rica	61.5
27.	Cyprus	51.0
28.	Denmark	465.0
29.	Dominican Republic	82.5
30.	Ecuador	105.0
31.	Egypt	342.0
32.	El Salvador	64.5
33.	Equatorial Guinea	15.0
34.	Ethiopia	54.0
35.	Fiji	27.0
36.	Finland	393.0
37.	France	2,878.5
38.	Gabon	45.0
39.	Gambia, The	13.5
40.	Germany, Federal Republic of	3,234.0

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		Proposed Maximum Quota (In millions of SDRs)
41.	Ghana	159.0
42.	Greece	277.5
43.	Grenada	4.5
44.	Guatemala	76.5
45.	Guinea	45.0
46.	Guinea-Bissau	5.9
47.	Guyana	37.5
48.	Haiti	34.5
49.	Honduras	51.0
50.	Iceland	43.5
51.	India	1,717.5
52.	Indonesia	720.0
53.	Iran	1,075.0
54.	Iraq	234.1
55.	Ireland	232.5
56.	Israel	307.5
57.	Italy	1,860.0
58.	Ivory Coast	114.0
59.	Jamaica	111.0
60.	Japan	2,488.5
61.	Jordan	45.0
62.	Kampuchea, Democratic	25.0
63.	Kenya	103.5
64.	Korea	255.9
65.	Kuwait	393.3
66.	Lao, People's Democratic Republic of	24.0
67.	Lebanon	27.9
68.	Lesotho	10.5
69.	Liberia	55.5
70.	Libyan Arab Republic	298.4
71.	Luxembourg	46.5
72.	Madagascar	51.0
73.	Malawi	28.5
74.	Malaysia	379.5
75.	Maldives	1.4
76.	Mali	40.5
77.	Malta	30.0
78.	Mauritania	25.5
79.	Mauritius	40.5
80.	Mexico	802.5

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		Proposed Maximum Quota (In millions of SDRs)
81.	Morocco	225.0
82.	Nepal	28.5
83.	Netherlands	1,422.0
84.	New Zealand	348.0
85.	Nicaragua	51.0
86.	Niger	24.0
87.	Nigeria	540.0
88.	Norway	442.5
89.	Oman	35.1
90.	Pakistan	427.5
91.	Panama	67.5
92.	Papua New Guinea	45.0
93.	Paraguay	34.5
94.	Peru	246.0
95.	Philippines	315.0
96.	Portugal	258.0
97.	Qatar	66.2
98.	Romania	367.5
99.	Rwanda	34.5
100.	São Tomé & Principe	3.0
101.	Saudi Arabia	1,040.1
102.	Senegal	63.0
103.	Seychelles	2.0
104.	Sierra Leone	46.5
105.	Singapore	92.4
106.	Solomon Islands	3.2
107.	Somalia	34.5
108.	South Africa	636.0
109.	Spain	835.5
110.	Sri Lanka	178.5
111.	Sudan	132.0
112.	Suriname	37.5
113.	Swaziland	18.0
114.	Sweden	675.0
115.	Syrian Arab Republic	94.5
116.	Tanzania	82.5
117.	Thailand	271.5
118.	Togo	28.5
119.	Trinidad and Tobago	123.0
120.	Tunisia	94.5

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ATTACHMENT I
ANNEX B

		Proposed Maximum Quota (In millions of SDRs)
121.	Turkey	300.0
122.	Uganda	75.0
123.	United Arab Emirates	202.6
124.	United Kingdom	4,387.5
125.	United States	12,607.5
126.	Upper Volta	24.0
127.	Uruguay	126.0
128.	Venezuela	990.0
129.	Viet Nam, Socialist Republic of	135.0
130.	Western Samoa	4.5
131.	Yemen Arab Republic	19.5
132.	Yemen, People's Democratic Republic of	61.5
133.	Yugoslavia	415.5
134.	Zaire	228.0
135.	Zambia	211.5

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